Chapter Seven

Options to Increase Revenues

REV-01 Limit the Mortgage Principal on Which Interest Can Be Deducted to $300,000

	Added Revenues (Billions of dollars)
2002	2.8
2003	4.1
2004	4.5
2005	4.9
2006	5.4
2002-2006	21.7
2002-2011	55.8

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-02

Buying a home is the largest investment that most Americans make, and the tax code has historically treated homes more favorably than other investments. Most investments pay their return in cash that is subject to income taxes. Homes, however, pay their return in housing “services” provided directly to the owner, and that return is not taxed. Furthermore, the tax code allows homeowners who help finance their purchase with a mortgage to claim the interest paid on that loan as a tax deduction. (Normally, interest can be deducted only if an investment earns taxable income.) In addition, most capital gains from sales of homes are exempt from taxation.

By limiting deductions of mortgage interest, policymakers could lessen the preferential treatment of home ownership for owners who must borrow to purchase their homes. Under current law, taxpayers may deduct interest on up to $1 million of debt that they have incurred to acquire and improve first and second homes. They may also deduct interest on up to $100,000 of other loans that they have secured with a home (for example, home-equity loans), regardless of the loan’s purpose. No other type of consumer interest is deductible. (Current law also limits how much the interest deductions for carrying assets other than first and second homes can exceed the income from such assets.)

Reducing the amount of principal eligible for the mortgage interest deduction from $1 million to $300,000 would trim deductions for 1.2 million taxpayers with large mortgages and increase revenues by $55.8 billion over the 2002-2011 period. That change would reduce the deduction only for the small fraction of people who own relatively expensive homes. (In 2000, 7 percent of new mortgages exceeded $300,000.) The percentage of homeowners affected would be greatest in high-cost areas such as Honolulu, San Francisco, Los Angeles, and New York City.

Research has shown that the tax code’s preferential treatment of home ownership encourages people to become homeowners and to purchase larger homes. Increasing home ownership, advocates say, contributes to social and political stability by strengthening people's stake in their communities and governments. In addition, home ownership may stabilize neighborhoods by encouraging people to live there longer than they might otherwise, to improve their homes, and to be concerned about their neighborhoods. The size of the tax preference, however, is probably larger than is needed to maintain a high rate of home ownership among people buying homes valued at more than $300,000. Canada achieves about the same rate of home ownership as the United States does without allowing taxpayers to deduct interest on their mortgages. Instead of the deduction, some provinces provide a limited tax credit for low- and middle-income people who save for a down payment.

A disadvantage of treating home ownership more favorably than other investments is that it reduces the savings available for investing in business enterprises whose returns are taxable and, in some cases, investing in education and training. Between one-quarter and one-third of net private investment typically goes into owner-occupied housing. Consequently, less investing in owner-occupied housing could noticeably raise investing in other sectors.

REV-02 Limit the Mortgage Interest Deduction for Second Homes

	Added Revenues (Billions of dollars)
2002	0.5
2003	0.7
2004	0.7
2005	0.8
2006	0.8
2002-2006	3.5
2002-2011	7.8

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-01

Taxpayers who borrow to purchase or improve a second home may deduct the interest on that mortgage under the same terms as those for a first home. The only limit on the amount borrowed for the two homes is that it be under $1 million. Furthermore, equity in both homes may be used as collateral to borrow up to $100,000 that can be used for any purpose and whose interest may be deducted. (Home-equity loans are an example of borrowing that qualifies for such a deduction.)

This option would limit the deductibility of mortgage interest to debt that taxpayers incur to acquire and improve a primary residence, plus $100,000 of other debt secured by that home. Under that approach, taxpayers could deduct the interest on loans for second homes only to the extent that the loans qualified under the $100,000 limit on home-equity borrowing. The limitation would increase revenues by $7.8 billion over the 2002-2011 period.

Several arguments for and against restricting the deductibility of all mortgage interest appear in option REV-01. Additional considerations apply to interest on mortgages for second homes. On the one hand, permitting some taxpayers to deduct the interest from those mortgages—many of which finance vacation homes—may seem inequitable when other taxpayers cannot deduct interest from consumer loans used to pay for medical expenses or other needed purchases. On the other hand, restricting the deduction of mortgage interest to a single home may be inequitable as well. Taxpayers with a big bill for interest on a mortgage for a costly primary home would keep the current deduction. But the deduction would be partially denied to other taxpayers who paid the same amount of total interest but on mortgages for two less-costly homes.

REV-03 Limit Deductions of State and Local Taxes to the Amount Exceeding 2 Percent of Adjusted Gross Income

	Added Revenues (Billions of dollars)
2002	6.0
2003	20.3
2004	20.8
2005	21.4
2006	21.8
2002-2006	90.3
2002-2011	205.3

SOURCE: Joint Committee on Taxation.

In determining their taxable income, taxpayers may either claim a standard deduction or itemize certain specific expenses and deduct them from their adjusted gross income (AGI). Such expenses include state and local taxes on income, real estate, and personal property. For taxpayers who itemize, those deductions essentially provide a federal subsidy for state and local tax payments. Consequently, the deductions indirectly finance increased spending by state and local governments at the expense of other uses of federal revenues. This option would establish a floor on deductions for state and local tax payments, limiting deductibility to the amount in excess of 2 percent of a taxpayer's AGI.

One of the arguments made for allowing taxpayers to deduct state and local tax payments is that the practice helps mitigate the effect of differences in taxes among the states. This option would continue some of that mitigating effect and increase federal revenues by about $205 billion over the 2002-2011 period. An alternative approach would be to prohibit deductions for payments above a fixed ceiling, which might also be a percentage of AGI. A ceiling of 5.85 percent of AGI, for example, would increase revenues by about the same amount—$209 billion in 2002 through 2011. However, a floor and a ceiling would have very different effects on incentives for spending by state and local governments. A floor would encourage spending, whereas a ceiling would discourage it.

As a way to assist state and local governments, the deductibility of state and local taxes has several disadvantages. First, it benefits only taxpayers who itemize their expenses and not people who claim the standard deduction. Second, because the value of an additional dollar of deductions increases with the marginal tax rate (the rate on the last dollar earned), the deductions are worth more to taxpayers in higher income tax brackets. Third, deductibility favors wealthier communities. Communities with a higher average level of income have more residents who itemize than do lower-income communities. Because deductibility benefits only people who itemize and wealthier communities have a greater proportion of such taxpayers, public spending in those localities receives a bigger federal subsidy. Fourth, deductibility may deter states and localities from financing services with nondeductible user fees, thereby discouraging more efficient pricing of some services.

One argument against restricting deductibility is based on equity. A taxpayer with a large liability for state and local taxes is less able to pay federal taxes than a taxpayer with the same total income and a smaller state and local tax bill. In some areas, however, a taxpayer who pays higher state and local taxes may benefit from more publicly provided services, such as recreational facilities. In that case, the taxes are similar to payments for other goods and services (for example, private recreation) that are not deductible. Alternatively, higher public expenditures resulting from deductibility benefit all members of a community, including lower-income taxpayers who do not itemize and thus receive no direct tax savings.

REV-04 Limit Deductions for Charitable Gifts of Appreciated Property to the Gifts' Tax Basis

	Added Revenues (Billions of dollars)
2002	0.3
2003	2.0
2004	2.1
2005	2.1
2006	2.2
2002-2006	8.7
2002-2011	20.3

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-05, REV-28-A, REV-28-B, and REV-29

Under current law, taxpayers who itemize deductions may deduct the value of contributions they make to qualifying charitable organizations up to a maximum of 50 percent of adjusted gross income in any year. In addition to donating cash, taxpayers may contribute assets such as stocks or art. The tax code gives special treatment to taxpayers who contribute property that has appreciated in value. If the taxpayer has held the property for more than 12 months, he or she may deduct its fair market value at the time of the gift regardless of its original price.

This option would limit the deduction for appreciated property to its tax basis—the initial cost of the asset plus the cost of any subsequent improvements and minus any deductions for depreciation. That change would increase revenues by about $0.3 billion in 2002 and more than $20 billion over 10 years.

The existing provision allows taxpayers to deduct the entire value of assets they contribute to charities even though they have paid no tax on gains from appreciation of the assets. That outcome treats one kind of donation more advantageously than others—for example, cash—and expands the preferential treatment of capital gains in the tax code (see options REV-28-A, REV-28-B, and REV-29). Indisputably, however, the current provision encourages people to donate appreciated assets to eligible charities rather than leave them to their heirs at death, when any gains also escape income tax (see option REV-05).

Through the deduction for charitable contributions, the federal government provides significant support for philanthropic activities. But one criticism of the deduction involves its inequity: the subsidies that the government provides for contributions vary for different taxpayers. The rate of the subsidy for the highest-income taxpayers can approach 40 percent of their contributions (essentially, the marginal tax rate), but the rate is only 15 percent for taxpayers in the lowest tax bracket. Moreover, there is no benefit for people who do not itemize deductions. Another criticism is that the electorate as a whole, and not individual donors, should make decisions about which charitable activities deserve support by taxpayers.

REV-05 Limit Deductions for Charitable Giving to the Amount Exceeding 2 Percent of Adjusted Gross Income

	Added Revenues (Billions of dollars)
2002	1.8
2003	11.8
2004	12.3
2005	12.9
2006	13.6
2002-2006	52.4
2002-2011	131.5

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-04

Current law allows taxpayers who itemize to deduct the value of contributions they make to qualifying charitable organizations up to a maximum of 50 percent of adjusted gross income (AGI) in any year. It also permits taxpayers to deduct contributions of appreciated property at their fair market value at the time of the gift, rather than at their original value (see option REV-04). In 1997, 32.6 million taxpayers claimed just over $99.2 billion of deductions for charitable contributions, reducing federal revenues by about $25 billion.

This option would limit the charitable deduction but retain an incentive for giving by allowing taxpayers to deduct only contributions that exceed 2 percent of AGI. That approach would increase revenues by about $1.8 billion in 2002 and about $131.5 billion over the 2002-2011 period.

The limit proposed in this option would retain the incentive for increased giving by people who donate a large share of their income but remove the incentive for people who contribute smaller amounts. The option would completely disqualify the deductions for charitable giving of about 19.1 million taxpayers in 2001 and would reduce allowed deductions for roughly another 15.6 million. Overall, the change would eliminate the tax incentive for just over half of the taxpayers who currently make and deduct such gifts. As a result, total charitable giving would decline. In addition, establishing a floor of 2 percent on contributions would encourage taxpayers who planned to make gifts over several years to lump them together in one tax year to qualify for the deduction.

REV-06 Phase Out the Child and Dependent Care Credit

	Added Revenues (Billions of dollars)
2002	0.5
2003	1.9
2004	1.9
2005	1.8
2006	1.7
2002-2006	7.8
2002-2011	15.3

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-14

Taxpayers who incur employment-related expenses for the care of children and certain other dependents may claim a credit against their income taxes. The credit, which is calculated per dollar of qualifying expenses, declines from 30 percent for taxpayers whose adjusted gross income (AGI) is $10,000 or less to 20 percent for taxpayers whose AGI is $28,000 or more. Tax law limits credit-applicable expenses to $2,400 for one dependent and $4,800 for two or more. The maximum credit each year for a taxpayer with one dependent and income above $28,000 is thus $480. Credit-applicable expenses cannot exceed the earnings of the taxpayer or, in the case of a couple, the earnings of the spouse with lower earnings. In 1998, taxpayers claimed about $2.5 billion in credits on 6 million tax returns.

About two-fifths of the credit goes to taxpayers with AGI of $50,000 or more. Retaining the credit only for lower-income families would reduce its cost in lost revenues. One way to do that is to lower the credit as income rises. For example, trimming the credit by 1 percentage point for each $1,500 of AGI over $30,000—and thus eliminating it completely for families with AGI over $58,500—would raise $15 billion from 2002 through 2011. That option would reduce or eliminate the credit for about 72 percent of currently eligible families. Alternatively, phasing out the credit for taxpayers with AGI between $50,000 and $78,500 would raise about $11 billion in the same period and would reduce or eliminate the credit for nearly half of all eligible families. Finally, phasing out the credit between $65,000 and $93,500 would raise $8 billion over the 10-year period and reduce or eliminate the credit for about one-third of eligible families.

Through the credit, the federal government pays a portion of the employment-related expenses that some taxpayers incur for care of their children and dependents. Phasing out the credit for higher-income families would target that subsidy toward families with lower incomes. At the same time, however, the reduced credit might discourage some people from working outside the home.

In some circumstances, the budgetary savings from this option could be smaller than those presented here. Current law allows workers to exclude from their taxable income up to $5,000 of annual earnings used to pay for dependent care through qualifying employer-sponsored programs. If more employers offered such programs in response to the loss of the credit by their employees, the lower revenues from the excluded earnings under those plans could offset the savings from this option. To realize more of those savings, the Congress could limit the use of employer-sponsored care (see option REV-14).

REV-07 Include Social Security Benefits in Calculating the Phaseout of the Earned Income Tax Credit

	Added Revenues[a] (Billions of dollars)
2002	b
2003	0.9
2004	0.9
2005	0.9
2006	1.0
2002-2006	3.7
2002-2011	9.0

SOURCE: Joint Committee on Taxation.

a. Includes outlay savings.

b. Less than $50 million.

Under current law, the earned income tax credit (EITC) phases out as the larger of earned income or adjusted gross income (AGI) exceeds a certain threshold. For that phaseout, the Taxpayer Relief Act of 1997 expanded the definition of AGI to include tax-exempt interest and nontaxable distributions from pensions, annuities, and individual retirement accounts that have not been rolled over into similar vehicles. However, that modified AGI still excludes most income from government transfer programs such as Social Security.

As a result of the exclusion, low-income families that receive sizable transfers can claim the EITC with the same total income that will reduce or deny the credit to otherwise comparable families whose income is fully included in their AGI. The tax code already requires some Social Security benefits to be counted: for single taxpayers with income above $25,000 and joint filers with income above $32,000, AGI includes up to half of any Social Security benefits. This option would require taxpayers to include all Social Security benefits in a modified AGI used for phasing out the EITC. That change would increase federal revenues and decrease outlays for the credit by about $1 billion in 2003 and $9 billion over the 2002-2011 period.

One argument supporting this option is that it would make the EITC fairer. Counting all Social Security benefits in the calculation for phasing out the credit would give the same EITC to both low-income taxpayers receiving Social Security and claiming the credit and otherwise comparable taxpayers whose income derives entirely from sources that are fully included in AGI. In addition, because the Internal Revenue Service (IRS) already receives information on taxpayers' Social Security benefits, administering this option would require only minor procedural changes.

The modified AGI would still exclude some transfers, however, and this option thus would not resolve the problem of families with the same total income receiving different credits. Another issue is the option's implementation. The IRS does not currently receive information on most forms of taxpayers' transfer income other than Social Security. As a result, requiring taxpayers to count all such income would substantially expand the information reported to the IRS and markedly increase taxpayers' "costs" for compliance (for example, time spent filling out forms). Furthermore, because most transfer income not included in AGI is from means-tested programs, counting all transfers in phasing out the EITC would offset, at least in part, the goal of providing income to poor recipients. Even so, excluding any transfers from the income measure used to phase out the credit would result in differential treatment of otherwise similar taxpayers.

In addition, counting Social Security benefits for the EITC phaseout would increase the costs of compliance for Social Security recipients claiming the credit and would further complicate the already complex form such taxpayers must complete. Those outcomes would run counter to recent efforts to simplify procedures for claiming the EITC.

REV-08 Limit the Tax Benefit of Itemized Deductions to 15 Percent

	Added Revenues (Billions of dollars)
2002	43.3
2003	98.4
2004	103.8
2005	109.5
2006	115.7
2002-2006	470.7
2002-2011	1,162.4

SOURCE: Joint Committee on Taxation.

Current law allows taxpayers to reduce their taxable income by the amount of their itemized deductions. Taxpayers who itemize may deduct state and local income and property taxes, interest payments on their home mortgages, contributions to charity, employee business expenses, moving expenses, casualty and theft losses, and medical and dental expenses. Taxpayers benefit from itemizing if their deductions exceed the standard deduction. Current law limits some itemized deductions (such as the one for medical expenses) to the amount in excess of a percentage of a taxpayer's adjusted gross income; the law reduces all itemized deductions for high-income taxpayers.

The benefit taxpayers gain from itemizing deductions, like the benefit for all deductions, increases with their marginal tax bracket (the bracket that applies to the last dollar earned). For example, $10,000 in itemized deductions reduces taxes by $1,500 for a taxpayer in the 15 percent bracket, by $2,800 for a taxpayer in the 28 percent bracket, and by $3,960 for a taxpayer in the 39.6 percent bracket. Most taxpayers, however, do not itemize deductions. Of the 30 percent of taxpayers who do, about half are in tax brackets above 15 percent. This option would limit the tax benefit for those higher-bracket taxpayers to 15 percent of their itemized deductions. It would increase revenues by about $471 billion over five years and about $1.2 trillion over 10 years.

Reducing the benefit from itemizing deductions would have several advantages, say supporters of this option. It would make the income tax more progressive by raising average tax rates for most middle- and upper-income taxpayers. And economists would argue that it might also improve economic efficiency because it would cut subsidies—provided in the form of lower taxes—that reduce the after-tax prices of selected goods, such as mortgage-financed, owner-occupied housing.

Opponents would argue, however, that the itemized deductions for health expenses, casualty losses, and employee business expenses are not subsidies of voluntary activities but rather allowances provided by the tax code for costs that reduce a person's ability to pay income tax. Under this option, some taxpayers would pay tax on the income that they used to defray such costs—because they would pay tax on their gross income at rates above 15 percent but could deduct only 15 percent of the cost of earning that income. Thus, a person with unusually high medical bills, for example, would pay more tax than another person with the same ability to pay but with low medical bills.

Like other restrictions on itemized deductions, the one outlined in this option would create incentives for taxpayers to avoid the constraint by converting itemized deductions into reductions in income. For example, taxpayers might liquidate some of their assets to repay mortgage loans, thus reducing both their income (from the assets) and their mortgage payments. Or they might donate time or services to charities rather than cash. The option would also make calculating taxes more complex for people who itemize.

REV-09 Eliminate Tuition Tax Credits for Postsecondary Education

	Added Revenues (Billions of dollars)
2002	3.2
2003	4.3
2004	4.3
2005	4.3
2006	4.3
2002-2006	20.4
2002-2011	41.3

SOURCE: Joint Committee on Taxation.

In recent years, policymakers have established two tax credits to help students and their families finance postsecondary education:

- The Hope credit is available to cover up to two years of tuition and fees that qualify under the program's rules. The credit, which is applied directly against individual income taxes, equals 100 percent of the first $1,000 in qualifying expenses and 50 percent of the next $1,000 for each family member.

- The lifetime learning credit is capped at 20 percent of the first $5,000 ($10,000 after 2002) of a family's total qualified expenses.

A taxpayer may claim both credits but not for the same student. The credits, which are effectively subsidies from the federal government, phase out when taxpayers' incomes reach specific amounts (between $40,000 and $50,000 for single returns and between $80,000 and $100,000 for joint returns). Eliminating the credits would raise $41.3 billion between 2002 and 2011.

Proponents and opponents of the credits have differing views about what the credits accomplish. According to proponents, the credits remedy a failing of capital markets in the private sector, which are not always ready to lend money to potential students whose only collateral is their future earnings. But that problem, say opponents, is already being addressed. The federal government helps students pay for postsecondary studies by guaranteeing loans that private-sector lenders make and by lending money directly.

Even in a context of no capital market failure, the credits might still be valuable if they encouraged more investment in education and the additional education yielded benefits to the community over and above the direct benefits to the student. Economic theory indicates, however, that financial help covering only part of a student's educational costs—help that does not affect the marginal, or last, dollar spent—has little influence on the amount of schooling the student obtains. For most recipients, the credits are pure income transfers, representing windfall gains that have little effect on enrollments. Furthermore, because the credits are not refundable, they do little to encourage low-income families to invest in postsecondary education.

Arguments against eliminating the credits can also be made, however. Without them, investment in education would decline, if only by a small amount, with some students reducing the amount of schooling they obtained. In addition, to the extent that the credits were intended to offset the already substantial and rising costs of higher education, removing them would block that effect.

REV-10 Substitute a Tax Credit for the Exclusion of Interest Income on State and Local Debt

	Added Revenues (Billions of dollars)
2002	0.2
2003	0.5
2004	0.9
2005	1.2
2006	1.6
2002-2006	4.4
2002-2011	16.8

SOURCE: Joint Committee on Taxation.

The tax code allows owners of state and local bonds to exclude the interest they earn on those bonds from their gross income—and thus from income tax. As a result, state and local governments pay lower interest rates on such bonds than would be paid on bonds of comparable risk whose interest was taxable. The revenues that the federal government forgoes exceed $20 billion per year and effectively subsidize (pay a portion of) the costs that state and local governments incur when they borrow.

This option would replace the exclusion of interest income on new issues of state and local debt with a tax credit that, unlike most credits, would be included in adjusted gross income. Under the option, the bondholder would receive a taxable interest payment from the state or local government issuing the bond plus the tax credit equaling 28 percent of the interest payment. The option would retain existing restrictions that now apply to the issuance of tax-exempt bonds. Adopting the tax credit would raise $16.8 billion over the 2002-2011 period.

Switching to a tax credit rather than excluding interest paid on state and local debt from the gross income of bond purchasers would yield several benefits. It could reduce state and local borrowing costs by a similar percentage but with a smaller loss of federal revenues. The loss would be smaller because switching to a credit would eliminate gains for bondholders in higher marginal tax brackets that exceeded the investment return necessary to induce them to buy the bonds. In addition, the size of the tax credit could be varied to allow the Congress to adjust the size of the federal subsidy—on the basis of perceived benefit to the public—for different categories of state and local borrowing. Nevertheless, substituting a tax credit for the exclusion would keep the bond subsidy akin to an entitlement.

The switch to a tax credit would also have some drawbacks, however. For example, it would reduce the after-tax return of people with higher marginal tax rates and thus lead them to buy fewer bonds. If that drop in demand for bonds was not offset by increased demand from other investors, state and local borrowing costs would be reduced by a smaller percentage, and interest rates on state and local debt would rise. Paying higher rates for borrowing could lead state and local governments in turn to reduce investments in capital facilities.

REV-11 Impose an Excise Tax of 3 Percent on Nonretirement Fringe Benefits

	Added Revenues (Billions of dollars)
2002	6.4
2003	9.0
2004	9.6
2005	10.1
2006	10.8
2002-2006	45.9
2002-2011	110.0

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-12, REV-13, REV-14, and REV-21

Unlike compensation paid to employees in cash, many fringe benefits are exempt from income and payroll taxes, resulting in lost revenues to the federal government. Exempting employer-paid health and life insurance premiums leads to the biggest loss—in 2001, about $71 billion in income taxes and $49 billion in payroll taxes. In addition to those exemptions, the law explicitly excludes from gross income dependent care paid for by an employer and miscellaneous benefits such as employee discounts and parking whose value is below a specified limit. Imposing an excise tax on fringe benefits would diminish the revenues lost as a result of those exclusions.

By excluding fringe benefits from gross income, the federal government effectively subsidizes their cost, leading people to consume more of such benefits than they would if they had to pay the full price. As a consequence, society's resources may be allocated inefficiently. For example, excluding employer-provided health insurance from taxation has probably led to greater spending on health care services than would have occurred if firms and workers had been faced with the actual cost of health insurance (see option REV-12).

A further disadvantage of such exclusions is their inequity. People whose compensation is paid all in cash pay more tax than people who have the same total income but are paid partly in fringe benefits. Moreover, because the tax exclusion is worth more to taxpayers in higher tax brackets and because higher-income taxpayers receive more fringe benefits than lower-income people, the tax savings from the exclusion are unevenly distributed among income groups.

Making all fringe benefits taxable to recipients is not without its difficulties, however, particularly in valuing benefits and assigning their value to individual employees. That problem could be avoided by imposing an excise tax on employers linked to the value of the benefits they provide. Those benefits would include the employer's share of health insurance (see option REV-12), premiums for the first $50,000 of employer-paid life insurance (see option REV-13), dependent care (see option REV-14), athletic facilities, employee discounts, and parking with a value up to the amount above which it is currently taxed. (Under current law, employees in 2000 must include in their taxable income the market value in excess of $175 per month of any parking provided free of charge by an employer.) Imposing an excise tax of 3 percent on fringe benefits, for example, would raise $110 billion from 2002 through 2011. The bulk of those revenues would come from taxing employer-paid health insurance.

This option would require employers to report only their total costs for fringe benefits. Because the rate of the excise tax would be much lower than the rate of the tax on wages, this option would maintain most of the incentive for employers to provide fringe benefits instead of taxable wages. For employees in higher-wage firms, an excise tax on employers would be relatively more favorable than including fringe benefits in employees' taxable income because unlike income tax rates, the rate of the excise tax would not rise with income.

REV-12 Limit the Tax Exemption for Employer-Paid Health Insurance

	Added Revenues (Billions of dollars) Income Tax	Payroll Tax
2002	8.9	6.7
2003	13.7	10.3
2004	15.3	11.5
2005	17.2	12.8
2006	19.4	14.2
2002-2006	74.5	55.5
2002-2011	214.9	156.3

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-11 and REV-21

RELATED CBO PUBLICATION:

The Tax Treatment of Employment-Based Health Insurance (Study), March 1994.

Employees do not pay taxes on income they receive in the form of employer-paid health insurance. In addition, the tax code generally excludes health insurance premiums and health care costs paid through cafeteria plans from income and payroll taxes. Excluding those benefits from taxation will reduce revenues from income and payroll taxes by a total of about $120 billion in 2001.

This option would limit the exemption of employer-paid health insurance and recoup some of those lost revenues. Specifically, it would treat as taxable income for employees any contributions that their employer makes for health insurance plus health care costs paid through cafeteria plans that together exceed $500 a month for family coverage and $200 a month for individual coverage. (Those ceilings are estimated average contributions for 2001; they would be indexed to reflect future increases in the general level of prices.) The option would increase income tax revenues by $214.9 billion and payroll tax revenues by $156.3 billion over the 2002-2011 period. Including employer-paid coverage for health care in the Social Security wage base, however, would increase future outlays for Social Security benefits. Over the long run, those outlays could offset a significant part of the added payroll tax revenues from this option.

Eliminating the incentive that the tax code now offers employees to purchase additional coverage beyond the ceiling could have broader consequences than its effects on revenues. It would encourage employees to economize in the medical marketplace, which could reduce both upward pressure on medical care prices and the use of unnecessary services or those of marginal value. The option could constrain health care costs even more over time because it would index the ceilings to the overall rate of inflation and health care costs have been rising faster than that. The Congress has already limited the exclusion for employer-paid group term life insurance in a similar way.

The option, however, has drawbacks that may argue for treating it differently from a life insurance benefit. One disadvantage of limiting the exemption of employer-paid medical insurance premiums is the difficulty of determining when extensive coverage becomes excessive. In addition, the coverage purchased by a given premium depends on such factors as geographic location and the characteristics of a firm's workforce. As a result, a uniform ceiling would have uneven effects. Furthermore, if the cost of health insurance continued to rise faster than the general level of prices, indexing to reflect that level would gradually reduce subsidies for employer-paid health insurance. Taken together, those factors could increase the number of workers without health insurance and generate inequities among taxpayers by region and type of employer.

REV-13 Include Employer-Paid Life Insurance in Taxable Income

	Added Revenues (Billions of dollars)	
	Income Tax	Payroll Tax
2002	1.1	0.6
2003	1.6	0.9
2004	1.7	1.0
2005	1.7	1.0
2006	1.8	1.1
2002-2006	7.9	4.6
2002-2011	17.6	10.4

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-11, REV-18, and REV-21

Tax law excludes from taxable income the premiums that employers pay for employees' group term life insurance, but it limits that exclusion to the cost of premiums for the first $50,000 of insurance. (The exclusion is not available to self-employed people.) Of the fringe benefits that offer a tax advantage to their recipients, employer-paid life insurance is the third most expensive in terms of lost revenues (after health insurance, discussed in option REV-12, and pensions). Including premiums for employer-paid life insurance in taxable income would add $17.6 billion to income tax revenues and $10.4 billion to payroll tax revenues from 2002 through 2011.

Excluding life insurance premiums from taxation has ramifications for both efficiency and equity. Like the tax exclusions for other employment-based fringe benefits, the exclusion for life insurance creates a subsidy for that benefit, which causes people to purchase more life insurance than they would if they had to pay the full cost of it themselves. Furthermore, excluding premiums from taxation allows workers whose employers purchase life insurance for them to pay less tax than workers who have the same total compensation but must purchase insurance on their own (see option REV-11). Those factors, which some people might view as arguments supporting this option, are reinforced by the relative ease with which the alternative could be implemented. The value of employer-paid life insurance, unlike the value of some other fringe benefits, can be accurately measured and allocated. Employers could report the premiums they paid for each employee on the employee's W-2 form and compute withholding in the same way as for wages. Indeed, employers already withhold taxes on the life insurance premiums they pay that fund death benefits above the $50,000 limit.

A tax subsidy to provide life insurance might be called for, however, in certain circumstances. One such case might be if people bought too little life insurance because they systematically underestimated the potential financial hardship to their families that their death might bring. Whether, in fact, people purchase too little insurance for that reason is unclear. Moreover, even if too little life insurance was purchased, a more efficient way of encouraging people to buy it might be to provide a direct tax subsidy to all purchasers and avoid subsidizing only people with insurance provided by employers.

REV-14 Eliminate the Tax Exclusion for Employer-Sponsored Dependent Care

	Added Revenues (Billions of dollars)
2002	0.7
2003	0.7
2004	0.7
2005	0.8
2006	0.8
2002-2006	3.7
2002-2011	9.1

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-06, REV-11, and REV-21

The tax system provides two kinds of subsidies for the expenses that working taxpayers incur for the care of children or other dependents. First, an employer may provide an arrangement for care, either directly or indirectly, essentially as a fringe benefit. The expenses for that care would then be excluded from the taxable income of the employee (lowering the employee's taxable wages and both the employer's and employee's liability for Social Security and Medicare payroll taxes). Second, employees who do not use employment-based subsidies may receive a tax credit, which is calculated as a percentage of their qualifying expenses for care. The two subsidies provide benefits for the same activities, but the subsidy from the employment-based tax exclusion can be much larger than that from the child and dependent care credit. Eliminating the exclusion and making all tax benefits for dependent care available only through the credit would swell revenues by $9.1 billion from 2002 through 2011.

Employers may exclude up to $5,000 for child and dependent care expenses from the taxable wages of their employees. That care, however, must either be provided by the employer directly or be obtained through other providers under a qualified plan that the employer has established. The tax code limits the maximum excluded amount to a taxpayer's earnings or, for married taxpayers, the earnings of the lesser-earning spouse. As with all types of exclusions, the value of the benefit depends on the taxpayer's marginal tax rate (the rate of tax on the last dollar earned).

Taxpayers who do not receive employment-based subsidies may claim a credit against their income tax. Current law limits the credit, which is nonrefundable, to annual expenses of $2,400 for one dependent and $4,800 for two or more dependents. As with the exclusion, the total amount of qualifying expenses may not exceed the earnings of the taxpayer or, in the case of a couple, those of the lower-earning spouse. The rate of the credit per dollar of qualifying expenses starts at 30 percent for taxpayers whose adjusted gross income (AGI) is $10,000 or less and then phases down to 20 percent for taxpayers whose AGI is $28,000 or more. The rate for most taxpayers is 20 percent, which results in a maximum credit of $480 for one dependent and $960 for two or more dependents. In 1998, about 6 million taxpayers claimed $2.5 billion in credits.

Even though they subsidize the same activities, the credit and the exclusion provide significantly different benefits. For example, under the employment-based exclusion, a high-income taxpayer with one child could receive an income tax benefit of up to $1,980 and a reduction in payroll taxes. Under the credit, the same taxpayer would receive a benefit of only $480 and no payroll-tax reduction. Eliminating the exclusion would treat taxpayers with similar dependent care circumstances more equitably because it would remove the advantage given to workers whose employers had established qualifying exclusion programs. It would also reduce complexity by simplifying taxpayers' calculations on their income tax forms.

Eliminating the exclusion, however, could have effects that might be considered negative. The total subsidies available for expenses related to child and dependent care would be smaller, which could induce some workers (particularly second earners in couples) to leave the labor force. A further argument against this option concerns whether expenses for dependent care are considered a cost of employment. The tax code allows taxpayers to exclude some of those costs. If dependent care is deemed to be a cost of employment, then eliminating the exclusion for it may be inappropriate.

REV-15 Limit the Tax Exclusion for Qualified Parking to Locations from Which Employees Commute in Vans and Carpools

	Added Revenues (Billions of dollars)
2002	0.7
2003	0.7
2004	0.7
2005	0.8
2006	0.8
2002-2006	3.7
2002-2011	9.0

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-21

The tax code allows employees to exclude from their taxable income the value of certain expenses for transportation that are paid by their employers. Those expenses include transportation in a van or other commuter highway vehicle, transit passes, and so-called qualified parking. (Qualified parking can be parking at or near an employer's place of business as well as parking provided at or near a place from which the employee commutes to work in a commuter highway vehicle or carpool.) The law limits the amount per month that can be excluded from an employee's income to $65 for commuter highway vehicles and transit passes and $175 for qualified parking. In effect, the tax exclusion provides a subsidy (in the form of lower taxes) from the federal government.

Under this option, employees would be able to exclude only their costs for parking at sites from which they continue on to work in a commuter highway vehicle or carpool and not their costs for parking at or near their job. The option would increase revenues by $9 billion over the 2002-2011 period.

By raising the cost of commuting by private vehicle, this option could lead workers to drive less and thereby reduce air pollution and traffic congestion. In economic terms, those outcomes might be more efficient than the current situation: because drivers do not bear the full cost of the air pollution and highway congestion they cause, they may drive more than is efficient. Subsidizing parking at work exacerbates that problem by further encouraging workers to drive. Additionally, because the subsidy for parking exceeds that for mass transit, workers who would otherwise be indifferent to which of the two modes of transportation they used will choose to commute by car.

Eliminating the subsidy for parking near their place of business will not coax all workers into using mass transit, vans, or carpools, however. Some drivers would continue to drive to work, even without a subsidy. For people who must drive to work, eliminating the subsidy would result in a transfer (as taxes paid on the value of transportation expenses covered by employers) from the worker to the Treasury rather than an incentive to pollute less. Furthermore, the current subsidies for mass transit may already offer an economically appropriate inducement for commuters to use public transportation rather than to drive. If so, reducing tax subsidies for parking could shift the balance too far in favor of mass transit. Finally, taxing the value of parking would increase the reporting employers are required to do and make completing tax returns more complicated for many workers.

REV-16 Include Employer-Paid Income-Replacement Insurance Premiums (Unemployment, Workers' Compensation, and Disability) in Taxable Income

	Added Revenues (Billions of dollars)
2002	9.5
2003	9.7
2004	9.6
2005	10.3
2006	11.0
2002-2006	50.1
2002-2011	116.0

SOURCE: Joint Committee on Taxation.

Current tax law treats benefits that replace income for unemployed and injured or otherwise disabled people in various ways. Unemployment benefits are fully taxable. Benefits under the workers' compensation program, however, are exempt from tax. How disability benefits (for non-work-related injuries) are treated depends on who paid the premiums for that insurance. If an employer paid them, the benefits are taxable (but the person's tax liability may be partially offset by the credit for the elderly or the disabled). If the employee paid the premiums out of after-tax income, the benefits are not taxed.

This option would eliminate some of the disparities in the tax code's treatment of such benefits. It would not tax income-replacement benefits, but it would treat as taxable income to the covered employee several premiums that employers pay, including taxes under the Federal Unemployment Tax Act and the various state unemployment programs, 60 percent of premiums for workers' compensation (excluding the portion that covers medical expenses), and the portion of insurance premiums or of contributions to pension plans that funds disability benefits. Altogether, those changes would increase revenues by $116 billion from 2002 through 2011.

Treating different kinds of income-replacement insurance similarly would have several advantages. It would eliminate the somewhat arbitrary distinctions in the taxation of various income-replacement benefits. And it would spread the tax burden among all workers covered by such insurance when they are well rather than place the burden on those unfortunate enough to need benefits (as is currently the case with unemployment benefits and employer-paid disability insurance).

This option could have downsides as well, however. Under current law, the income-replacement portion of adjudicated awards and out-of-court settlements for injuries not related to work and not covered by insurance is entirely exempt from tax. The treatment of employer-paid premiums under the option would be inconsistent with that approach. Moreover, treating unemployment insurance the way this option proposes would allow supplemental benefits that are occasionally appropriated by the Congress during especially lengthy periods of unemployment to escape taxation. A further effect of not taxing those benefits is that it would reduce the incentive for unemployed people to accept available work. Finally, calculating the portion of contributions to defined benefit pension plans that covers disability insurance would place an additional administrative burden on employers.

REV-17-A Tax Social Security and Railroad Retirement Benefits Like Private Pensions

	Added Revenues (Billions of dollars)
2002	10.4
2003	26.3
2004	27.3
2005	28.2
2006	29.1
2002-2006	121.3
2002-2011	283.7

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-17-B and REV-19

RELATED CBO PUBLICATION:

Reducing Entitlement Spending (Study), September 1994.

Under current law, most benefits from Social Security and Railroad Retirement are treated preferentially—that is, they are not subject to tax. Recipients pay tax only if the sum of their adjusted gross income (AGI), their nontaxable interest income, and one-half of their Social Security and Tier I Railroad Retirement benefits exceeds a fixed threshold. If that total is more than $25,000 for single returns or $32,000 for joint returns, up to 50 percent of the benefits are taxed. Above a second set of thresholds—$34,000 for single returns and $44,000 for joint returns—up to 85 percent of the benefits are taxed. Together, those levels constitute a three-tiered structure for taxing benefits.

Distributions from private pension plans are taxable except when those payments represent the recovery of an employee's after-tax contributions (or "basis"). To carry out that recovery, the pension plan calculates the accumulated after-tax contributions as a percentage of the total value of the account (for defined contribution plans) or the expected value of future benefits (for defined benefit plans). The percentage is applied to each year's distributions from the plan to determine the portion that is nontaxable. Once the employee has recovered his or her entire basis tax-free, all subsequent distributions are fully taxed.

A basis exists for Social Security and Railroad Retirement recipients as well, because employees (or self-employed people) pay 50 percent of the payroll taxes supporting those programs out of their after-tax income. This option would tax all Social Security and Railroad Retirement benefits in excess of that basis, which could be recovered in the same manner as for a private pension. Under such an approach, the taxable percentage of benefits would exceed 85 percent for the overwhelming majority of recipients, and revenues would increase by $283.7 billion between 2002 and 2011.

This option would make the tax system more equitable in at least two ways. First, it would eliminate preferences under the tax code that are now given to Social Security benefits but not to private pension benefits—both the slight preference accorded to higher-income taxpayers and the much larger preference given to low- and middle-income taxpayers. Second, it would treat elderly taxpayers in the same way that nonelderly taxpayers with comparable income are treated. In addition, the option would remove the deterrent to saving for retirement that is associated with the three-tiered tax structure (see REV-17-B for details) and make preparing tax returns for elderly people substantially simpler.

Set against those seemingly positive features, however, are several arguments against this option. One drawback is that under it, more elderly people would have to file tax returns than under current law. In addition, retirees might feel that increasing taxes on benefits violates the implicit promises of the Social Security and Railroad Retirement programs. Furthermore, calculating the percentage of each recipient's benefits to exclude from taxation would impose an additional burden on the Social Security Administration.

REV-17-B Include 85 Percent of Social Security and Railroad Retirement Benefits in Taxable Income for All Recipients

	Added Revenues (Billions of dollars)
2002	9.0
2003	22.8
2004	23.6
2005	24.3
2006	24.6
2002-2006	104.3
2002-2011	242.3

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-17-A and REV-19

RELATED CBO PUBLICATION:

Reducing Entitlement Spending (Study), September 1994.

Most benefits from the Social Security and Railroad Retirement programs are not subject to income taxation (see option REV-17-A for details). But about one-third of all households receiving benefits from those programs will pay income tax on some portion of the payments in 2002, and about one-half of those households will pay tax on 85 percent of their benefits. Those proportions will increase over time as nominal incomes rise relative to the unindexed thresholds that determine the percentage of benefits to be taxed.

This option would eliminate the current three-tiered tax structure and include 85 percent of Social Security and Railroad Retirement benefits in a recipient's taxable income—regardless of the amount of other income he or she receives. Taxing a flat 85 percent of benefits approximates the way the tax system treats private pensions, as option REV-17-A describes, and would increase revenues by $242.3 billion between 2002 and 2011.

This option would make the tax system more equitable by treating similar taxpayers in the same way. It would eliminate preferences that are now given to Social Security benefits received by low- and middle-income taxpayers but not given to private pension benefits received by people in the same income categories. It would also make the tax treatment of elderly taxpayers more like the treatment of nonelderly people with comparable income. Furthermore, this option would impose no administrative burden on the Social Security Administration and would make preparing tax returns substantially simpler. It would also eliminate the deterrent to saving for retirement faced by some workers under the three-tiered tax structure. Specifically, if part of their benefits fall above the taxable-income thresholds, they will pay a higher marginal tax rate on their income from savings. For example, an additional dollar of interest income not only incurs income tax but also makes another 50 cents or 85 cents of Social Security benefits subject to taxation.

The positive features of the option, however, are offset by certain drawbacks. One such disadvantage is that under this option, the treatment of Social Security benefits remains slightly preferential in comparison with that of private pension benefits. Another drawback is that the option would increase the number of elderly people who would have to file tax returns. Under current law, 61 percent of households receiving Social Security must file; this option would increase that proportion to 77 percent in 2002. Retirees might also feel that increasing taxes on benefits violates the implicit promises of the Social Security and Railroad Retirement programs.

Alternative formulas for taxing benefits would maintain a tiered structure but increase the taxable percentage in one of the lower tiers. For example, if the taxable percentage of benefits in the lowest tier was raised from zero to 50 percent, revenues over the 10-year period would increase by $115.9 billion, and the percentage of households that owed taxes would rise to 66 percent. If the lowest tier was left at zero but the middle tier was increased to 85 percent, revenues would rise by $72.8 billion and very few additional recipients would have to pay tax.

REV-18 Include Investment Income from Life Insurance and Annuities in Taxable Income

	Added Revenues (Billions of dollars)
2002	11.4
2003	23.2
2004	23.8
2005	24.5
2006	25.2
2002-2006	108.1
2002-2011	245.3

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-13

Life insurance policies and annuities often combine features of both insurance and tax-favored savings accounts. (An annuity is a contract with an insurance company under which a person pays a single premium, or a series of premiums, and the company provides a fixed or variable payment to that person at some future time, usually during retirement.) The investment income from the money paid into life insurance policies and annuities, sometimes called inside buildup, is not taxed until it is paid out to the policyholder. If it is left to the policyholder's estate or used to pay for life insurance (in the case, for example, of whole-life policies), it can escape taxation entirely. The tax treatment of inside buildup is similar to the taxation of capital gains.

Under this option, life insurance companies would notify policyholders annually—just as mutual funds do now—of the investment income realized on their account, and people would include those amounts in their taxable income. As a result, disbursements from life insurance policies and benefits from annuities would no longer be taxable as they were paid. Making the investment income taxable as it is realized would raise $245 billion in 2002 through 2011 and make its tax treatment equal to that of income from a bank account, taxable bond, or mutual fund. Tax on the investment income from annuities purchased as part of a qualified pension plan or qualified individual retirement account would still be deferred until benefits were paid.

Deferring taxes on the investment income from life insurance policies creates a tax incentive to purchase life insurance, which may or may not be useful. That kind of encouragement is desirable if people systematically underestimate the financial hardship that their death would impose on spouses and families. Such shortsightedness could cause them to buy too little life insurance. Similarly, it might cause people to buy too little annuity insurance to protect them against outliving their assets. To be useful, the incentive must also induce people to purchase significantly more insurance and annuity coverage, but it is not currently known by how much the incentive might increase that coverage. Provided that the incentive is, indeed, useful, a better approach might be to subsidize life insurance directly by giving people a tax credit for their insurance premiums or allowing them to take a partial deduction. Annuities already receive other tax subsidies through the special tax treatment of pensions and retirement savings.

The tax code’s favorable treatment, or “preference,” given to inside buildup in life insurance policies and annuities has an uncertain effect on saving. It may encourage saving because it increases people's income when they are older for each dollar they save when they are younger. It might, however, also reduce saving because it enables people to save less when they are younger without reducing the income they can expect when they are older.

REV-19 Include an Income-Related Portion of the Insurance Value of Medicare Benefits in Taxable Income

	Added Revenues (Billions of dollars)		
	Tax HI Only	Tax SMI Only	Tax Both
2002	3.3	2.1	5.6
2003	8.6	5.6	14.6
2004	9.4	6.3	16.2
2005	10.4	7.1	18.0
2005	11.6	8.0	20.0
2002-2006	43.3	29.1	74.4
2002-2011	119.9	83.7	209.0

SOURCE: Joint Committee on Taxation.

NOTE: HI = Hospital Insurance; SMI = Supplementary Medical Insurance.

RELATED OPTIONS:

REV-17-A, REV-17-B, 570-18, 570-19-A, and 570-19-B

RELATED CBO PUBLICATION:

Reducing Entitlement Spending (Study), September 1994.

Even though Social Security benefits are at least partially taxable under current law (see options REV-17-A and REV-17-B), Medicare benefits are not. For taxpayers whose income exceeds certain thresholds, this option would tax portions of the insurance value of Medicare Hospital Insurance (HI) and Supplementary Medical Insurance (SMI) by including them in adjusted gross income, or AGI. The insurance value of Medicare benefits, which does not depend on the services a recipient uses, is essentially the subsidy that the government would pay for each participant if Medicare were handled by a private insurance company.

Specifically, under this option, if a taxpayer's combined income (AGI plus nontaxable interest income plus one-half of Social Security, Railroad Retirement, and Medicare benefits) exceeded $34,000 ($44,000 for joint returns), 85 percent of the insurance value of HI and 75 percent of the value of SMI would be subject to taxation. (Those percentages roughly represent the share of the program's costs that are not paid for by recipients through either payroll taxes during their working years or SMI premiums.) For taxpayers with combined income below that threshold but above $25,000 ($32,000 for joint returns), 50 percent of the insurance value of both HI and SMI would be subject to taxation. This option would not affect taxpayers with income below $25,000 ($32,000 for joint returns). The thresholds, however, would not be indexed for inflation. Thus, as incomes rose over time, an ever-larger fraction of Medicare insurance benefits would become taxable.

From 2002 through 2011, taxing HI benefits alone would increase federal revenues by $119.9 billion, and taxing only SMI benefits would yield $83.7 billion. Imposing both taxes simultaneously would raise revenues by about $209 billion over 10 years. The combined tax would generate more revenues than the sum of the two taxes because some taxpayers would face higher rates as their AGI increased. Combining HI and SMI taxes would also push more enrollees above the income thresholds.

An alternative option would forgo income thresholds and tax 85 percent of the insurance value of HI benefits and 75 percent of the insurance value of SMI benefits for all recipients. With no income thresholds, the HI and SMI taxes would raise $318.9 billion over the 2002-2011 period.

Subjecting some portion of Medicare benefits to taxation could have several positive effects beyond increasing revenues. A tax on SMI benefits would shift some of that program's costs from taxpayers to enrollees. Administering this option would be straightforward because a mechanism is already in place for taxing Social Security benefits. In addition, as a counterbalance to concerns about the option's effects on lower-income enrollees, the use of income thresholds would be a plus since it would leave those enrollees unaffected. In fact, because many Medicare enrollees do not have to pay income taxes, this approach would affect only about 35 percent of them in 2002.

There are also arguments against this option, however. The tax would apply to in-kind benefits rather than cash income. As a result, some enrollees might contend that the additional taxable amounts do not represent cash with which to pay the taxes that might apply to them.

REV-20 Raise the Age Limit from 14 to 18 for Taxing Investment Income Under the Kiddie Tax

	Added Revenues (Billions of dollars)
2002	a
2003	0.1
2004	0.1
2005	0.2
2006	0.2
2002-2006	0.6
2002-2011	1.9

SOURCE: Joint Committee on Taxation.

a. Less than $50 million.

Under current law, investment income in excess of specified limits that is received by a dependent child under age 14 is taxed at the parents' marginal rate (the rate of tax on the last dollar earned). In 1999, the applicable limit on such income was $1,400. The provision—often referred to as the kiddie tax—is intended to restrict parents' ability to reduce the income tax on their investment income by transferring ownership of income-producing assets to their young children. It does not, however, preclude parents from cutting their tax bills by giving such assets to children older than 13. Under current law, income from assets in the name of a child over age 13 is taxed at the child's rate, which is generally 15 percent, rather than at the parents' rate, which can be as high as 39.6 percent. On annual income from assets that totals $10,000, for example, the difference in rates can cut the family's tax bill from $3,960 to $1,500, or by more than 60 percent.

This option would raise the age limit—from 14 to 18—below which a child's income from investments is taxed at the parents' rates. The option would increase income tax revenues by $2 billion over the 2002-2011 period.

Extending the kiddie tax to older children would help prevent parents from sheltering assets to reduce the taxes they have to pay. But the assets of older children may be their own. An older child may have earned and saved a substantial amount of money or may have received sizable gifts. In that case, it is reasonable to tax the income from those assets at the child's rate rather than the parents'. Indeed, imposing the parents' higher rate could discourage teenagers from saving earnings or gifts.

REV-21 Lower the Limits on Contributions to Qualified Pension Plans

	Added Revenues (Billions of dollars)
2002	1.4
2003	2.6
2004	2.7
2005	2.7
2006	2.7
2002-2006	12.2
2002-2011	27.4

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-11, REV-12, REV-13, REV-14, and REV-15

Employer-sponsored pension plans qualify for favorable tax treatment under current law. Employers can deduct their contributions to the plans from their taxable income. Employees receive a benefit as well: they do not have to declare the contributions as current income. Furthermore, the plans' investment earnings are tax-exempt. Taxes are paid only when pension recipients declare their benefits as income, normally in retirement. The tax code treats employees' contributions through 401(k) and related plans similarly. Deferring taxes allows investment earnings to accumulate faster; also, if people are in lower tax brackets when they retire, they pay lower taxes than they would have when the contributions were made and the earnings accrued.

However, the tax code limits the amounts that can be saved depending on the type of plan that employers offer. *Defined contribution plans* specify how much an employer will contribute—for example, 5 percent of pay—toward each employee's retirement. The pension that is paid depends on how much accumulates in that employee's retirement fund by the time he or she retires. Current law limits annual plan contributions to the lesser of 25 percent of compensation or $35,000 in 2001. In contrast, *defined benefit plans* specify how much employees will receive when they retire (for example, 1 percent of their final pay for each year of service). Employers adjust their annual retirement contributions to accumulate enough money to pay the promised pension by the time the employee retires. Current law limits pensions that begin at age 65 to no more than 100 percent of the worker's preretirement wages or a fixed amount ($140,000 in 2001), whichever is less. (The tax code reduces that limit on an actuarial basis for pensions that begin at an earlier age.) In addition to the limits it imposes on employers' contributions, the tax code restricts the amount that employees may contribute to plans with 401(k) and related arrangements. In 2001, the limit on such contributions is $10,500. When a firm sponsors both types of plans, the employer can deduct no more than 25 percent of the current compensation paid to employees covered by the plans.

This option would lower the limit on annual contributions to defined benefit plans from the current $140,000 to the Social Security wage base ($80,400 in 2001). It would also make proportionate reductions in the limits for defined contribution plans and employee contributions to plans with 401(k) and related arrangements. Those reductions would raise $27.4 billion in revenues from 2002 through 2011.

The main argument for reducing those limits is that the current restrictions allow employers to fund pensions that are much bigger than the preretirement earnings of most workers. Only 2 percent of full-time, full-year workers in 1998 earned more than $140,000 (the limit on employer-funded pensions). Workers who accrue pensions that large are unlikely to need the full tax advantage of the deferral to provide adequately for their retirement. Limiting funding to the Social Security wage base would still allow pensions greater than the earnings of 90 percent of all full-time, year-round U.S. workers.

Arguing against this option is the likelihood that decreasing the limits on pension contributions would reduce participation in retirement plans. Pension plans would become less attractive to high-income business owners and managers and thus they might sponsor fewer of them for both themselves and their employees. A substantial fraction of workers reach the age of retirement with few financial assets and only limited pensions. And workers may need such pensions even more in the future with Social Security facing long-term budgetary pressures. Moreover, economic theory suggests that treating all saving the way the tax code treats pension contributions would allow people to make better choices about their saving and their consumption. In recognition of those factors, the House of Representatives and the Senate Finance Committee approved legislation in 2000 that would raise the limits on pension contributions.

REV-22 Eliminate the Preferential Tax Treatment Afforded to Benefactors and Beneficiaries of Qualified State Tuition Programs

	Added Revenues (Billions of dollars)
2002	0.1
2003	0.1
2004	0.1
2005	0.2
2006	0.2
2002-2006	0.7
2002-2011	1.7

SOURCE: Joint Committee on Taxation.

The Small Business Job Protection Act of 1996 provided tax relief (among other things) that inspired states to create tuition programs for funding post-secondary education. Such programs allow benefactors to contribute to a savings account established to pay future expenses for higher education. The law considers those contributions to be gifts to the beneficiary; it treats earnings from the account as income to the student (and thus taxable) when he or she uses the funds to pay for educational expenses that qualify under the program's rules. Taxes on the earnings are thus deferred; when paid, the rate of tax is the (generally) lower rate of the student.

Under this option, the benefactor would remain the owner of the tuition funds and of any earnings on them. The earnings would thus be taxed as income to the benefactor when the funds were withdrawn and used for qualified educational expenses. The funds themselves would be treated as gifts to the beneficiary. Over the 2002-2011 period, this option would increase revenues by $1.7 billion.

Although some state tuition programs existed before the 1996 act, the law encouraged states that already had programs to establish more and states that had no programs to begin them. Currently, more than 40 states have tuition programs, and those states that do not are considering establishing them. The programs vary in complexity, in the types of expenditures they permit, and in how they are treated under the state's income tax rules.

Proponents of this option argue that changing the existing tax provisions would improve both efficiency (how the provisions affect economic activity and growth) and equity (fairness). In general, tuition accounts encourage benefactors to adjust their portfolios and savings plans solely to reduce their taxes rather than to increase the amount that they save. And for the most part, only families with higher incomes benefit from this tax relief. Lower-income families probably gain little because they have few extra funds to invest for future education needs. Moreover, because low-income benefactors and beneficiaries probably face similar marginal tax rates (the rate of tax on the last dollar earned), low-income benefactors are unlikely to see a significant drop in their tax bill. In addition, the tax code prohibits benefactors from using these accounts as, for example, security for loans, so they offer little advantage to lower-income taxpayers who would benefit from more-flexible vehicles for saving.

An argument in favor of treating these accounts as the law currently directs centers on the issue of fairness in taxing capital investments. The tax code treats investments in physical capital more favorably than investments in human capital. (For example, the law allows businesses to accelerate the expenses they claim for depreciating facilities and equipment and allows homeowners to deduct the interest on their home mortgages from their taxable income.) Allowing people to pay tax on the earnings of tuition accounts at beneficiaries' (generally) lower rates helps offset that imbalance.

REV-23 Expand the Medicare Payroll Tax to State and Local Government Employees Not Now Covered

	Added Revenues (Billions of dollars)
2002	1.1
2003	1.4
2004	1.3
2005	1.3
2006	1.2
2002-2006	6.3
2002-2011	10.7

SOURCE: Congressional Budget Office.

Certain groups of employees of state and local governments do not pay the Medicare payroll tax. (All federal employees have been covered since 1983, as required by the Tax Equity and Fiscal Responsibility Act of 1982.) The Consolidated Omnibus Budget Reconciliation Act of 1985 mandated that state and local employees who began work after March 31, 1986, pay Medicare payroll taxes, but it did not make coverage mandatory for people hired before that date. The Omnibus Budget Reconciliation Act of 1990 expanded Medicare tax coverage to include all state and local government employees not covered by any retirement plan.

Expanding the Medicare payroll tax to include all state and local government employees who are not now covered would raise $10.7 billion from 2002 through 2011. The annual gain in revenues would decline gradually as employees who were hired before April 1986 left the payrolls of state and local governments.

Only one out of eight state and local employees is not covered by Medicare through their employment, but most of those workers will still receive Medicare benefits when they retire. Under current law, many state and local employees will qualify for benefits on the basis of other employment in covered jobs or their spouse's employment.

Requiring all state and local employees to pay Medicare payroll taxes could be justified on grounds of fairness. The program's broader coverage would lessen the inequity of the high benefits those employees receive in relation to the payroll taxes they pay. Of course, expanding Medicare coverage to include more state and local employees would somewhat increase the federal government's liability for future benefits under the program. But the additional revenues would probably more than offset the permanent increase in benefits.

REV-24 Calculate Taxable Wages the Same Way for Both Self-Employed People and Employees

	Added Revenues (Billions of dollars) On-Budget	Off-Budget
2002	0.2	0.1
2003	0.2	0.2
2004	0.3	0.2
2005	0.3	0.2
2006	0.3	0.2
2002-2006	1.2	0.9
2002-2011	2.8	2.1

SOURCE: Congressional Budget Office.

Social Security and Medicare taxes come in two forms: the Federal Insurance Contribution Act (FICA) tax paid on wages and the Self-Employment Contribution Act (SECA) tax paid on income from self-employment. Under FICA, employees and employers each pay a Social Security tax of 6.2 percent on wages up to a taxable maximum ($80,400 in 2001) and a Medicare tax of 1.45 percent on all wages. Until 1983, the SECA rate was explicitly set lower than the combined employer and employee rate under FICA. As part of the Social Security Amendments of 1983, the Congress increased the effective SECA rates starting in 1984. The conference committee said that the law was "designed to achieve parity between employees and the self-employed" beginning in 1990.

Despite the Congress's stated intent, the current method for calculating SECA taxes allows a self-employed taxpayer to pay less tax than a worker with the same nominal income who is not self-employed. For example, an employee earning $50,000 and his or her employer each pay $3,825 in FICA taxes, so that employee's total compensation is $53,825 (the employer's share is considered compensation) and the total FICA tax is $7,650. But if that worker's self-employed sibling also earned total compensation of $53,825, he or she would pay only $7,605 in SECA taxes, $45 less than the employee sibling would pay. The difference arises because the self-employed sibling will have a calculated taxable income base that is lower than that of the employee sibling. Under current law, the income base on which self-employed people calculate their tax equals total compensation less 7.65 percent. Thus, the self-employed sibling pays taxes on $49,707, but the employee sibling pays taxes on $50,000.

Among people with earnings above Social Security's taxable maximum, self-employed workers pay the same amount of Social Security tax that employees pay, but they pay less Medicare tax. For example, an employee earning $100,000 and his or her employer each pay $4,501 in Social Security taxes and $1,450 in Medicare taxes, so that employee's total compensation is $105,951 and the total FICA tax is $11,902. That person's self-employed sibling—with the same total compensation—pays the same maximum Social Security tax but only $2,838 in Medicare taxes, or $62 less. (The self-employed person pays Medicare taxes on $97,846, whereas the employee pays Medicare taxes on $100,000.) High-income, self-employed taxpayers may pay as much as 6.3 percent less in Medicare taxes under SECA than employees with similar total compensation pay under FICA. That difference has existed since 1991, when the Congress first set the taxable maximum for Medicare higher than the taxable maximum for Social Security. Eliminating the difference would require a slight change to Schedule SE (the income tax form for reporting self-employment income), but it would directly affect only a relatively small percentage of self-employed taxpayers—those with income above the taxable maximum.

Changing the formula for calculating SECA taxes would increase on-budget revenues by $2.8 billion from 2002 to 2011. Off-budget SECA revenues, which are deposited in the Social Security trust funds, would increase by $2.1 billion.

REV-25 Subject All Earnings to the Social Security Payroll Tax

	Added Revenues (Billions of dollars)
2002	70.5
2003	97.1
2004	100.9
2005	105.0
2006	110.6
2002-2006	484.2
2002-2011	1,127.5

SOURCE: Congressional Budget Office.

Social Security—composed of the Old-Age, Survivors, and Disability Insurance (OASDI) programs—is financed by a payroll tax on employees, employers, and self-employed people. The receipts from that tax go into trust funds (essentially accounting mechanisms that the government uses to track receipts and spending for programs with specific taxes or other revenues earmarked for their use). Only earnings up to a specified maximum amount are taxed, although that amount automatically increases each year. (In 2001, the maximum amount of earnings taxed under Social Security is $80,400.) This option would make all earnings subject to the payroll tax, generating about $1.1 trillion in receipts from 2002 through 2011. Some of those revenues, however, would be offset by the additional retirement benefits Social Security would pay to people with income above the current law's maximum taxable amount.

When Social Security began in 1937, about 92 percent of the earnings from jobs covered by the program were below the maximum taxable amount. That percentage gradually declined over time because the maximum rose only occasionally, when the Congress enacted specific increases to it. In the 1977 amendments to the Social Security Act, the Congress intentionally boosted the earnings base: it raised the percentage of covered earnings subject to the tax to 90 percent by 1982 and automatically increased the ceiling each year thereafter by the growth in average wages. Despite that indexing, the fraction of taxable earnings has slipped over the past decade as a result of faster-than-average increases in the earnings of the highest-paid workers. In 1999, approximately 84 percent of earnings from employment covered by OASDI fell below the maximum.

Subjecting all earnings to the payroll tax, proponents of this option argue, would have several positive effects—for example, improving the solvency of the OASDI trust funds. Proponents also contend that the option would increase the progressivity of the payroll tax. Because people who have income above the ceiling do not pay the tax on all of their earnings, they pay a lower share of their total income in payroll taxes than do people whose total earnings fall below the maximum. Making all earnings taxable would raise payroll taxes for high-income earners, making the tax more progressive. Although that change would also entitle people with earnings above the old maximum to higher Social Security payments when they retired, the additional benefits would be small relative to the additional taxes those earners would have to pay.

Opponents of this option argue that it would weaken work incentives. In particular, it would reduce the additional rewards from working that people whose earnings are above the maximum now receive, because those earnings would become subject to the payroll tax. As a result, such workers would have an incentive to work less or to take more compensation in the form of fringe benefits that were not subject to payroll taxes. In the longer run, opponents contend, the option might also reduce the incentives workers have to invest in skills and education that generally lead to higher wages.

REV-26 Eliminate the Source Rules Exception for Inventory Sales

	Added Revenues (Billions of dollars)
2002	1.7
2003	3.6
2004	3.8
2005	4.1
2006	4.4
2002-2006	17.6
2002-2011	45.1

SOURCE: Joint Committee on Taxation.

RELATED CBO PUBLICATION:

Causes and Consequences of the Trade Deficit: An Overview (Memorandum), March 2000.

U.S. multinational corporations generally pay U.S. tax on their worldwide income, including the income they earn from operations of their branches or subsidiaries in other nations. Foreign nations also tax the income from those operations, and the U.S. tax code allows multinational firms to take a limited credit for that foreign income tax. The credit is applied against what the firms would have owed in U.S. taxes on that income, but it cannot exceed what they would have owed in the United States. If a corporation pays more foreign tax on the foreign income than it would have paid on otherwise identical domestic income, it accrues what the tax code calls excess foreign tax credits.

In contrast to income generated by operations abroad, the income corporations earn from products sold abroad but produced domestically results almost entirely from value created or added in the United States. Hence, the income U.S. firms receive from exports is typically not taxed by foreign nations. But the tax code's "title passage" rule specifies that the source of a gain on the sale of inventory is the place to which the legal title to the inventory "passes." If a firm exports its inventory abroad, the title passage rule allocates the income from those sales in a way that, in effect, sources half of it to the jurisdiction in which the sale takes place and half to the place of manufacture. In practice, that means that if the firm's inventory is manufactured in the United States and sold abroad, half the income from the sale is still treated as though it were foreign in source—even though the firm may have no branch or subsidiary located there and the foreign jurisdiction does not tax it.

The upshot of this rule is that a firm can classify more of its income from exports as foreign in source than could be justified solely on the basis of where the underlying economic activity occurred. A multinational firm with excess foreign tax credits can then use those credits to offset U.S. taxes on that foreign income. As a result, about half of the export income received by companies with such credits is effectively exempted from U.S. tax, and the income allocation rules essentially subsidize the U.S.-made products of some multinational corporations.

This option would replace the title passage rule with one that apportioned income on the basis of where a firm's economic activity actually occurred. The change would increase revenues by $1.7 billion in 2002 and $45.1 billion over the 2002-2011 period.

Export subsidies, such as those embodied in the title passage rule, do not boost overall levels of domestic investment and employment, nor do they affect the trade balance. They increase profits—and thus investment and employment—in industries that sell substantial amounts of their products abroad. But the U.S. dollar appreciates as a consequence, making foreign goods cheaper and thereby reducing profits, investment, and employment in U.S. firms that compete with imports. Export subsidies, therefore, like most subsidies, distort the allocation of resources so that the prices of the goods they affect no longer reflect the goods' production costs (either domestically or abroad).

Opponents of eliminating the title passage rule point to a perceived need to provide U.S. corporations with an advantage over foreign corporations operating in the same markets. However, corporations without excess foreign tax credits receive no advantage. Thus, the rule gives U.S. multinational exporters a competitive advantage over U.S. exporters that conduct all of their business operations domestically (and it gives U.S. multinational exporters that have excess foreign tax credits an advantage over those that do not).

Last, foreign tax credits granted under U.S. tax law were intended to prevent business income from being taxed both domestically and abroad. But the title passage rule allows export income that is not usually subject to foreign tax to be exempted from U.S. taxes as well—which means that the income escapes business taxation altogether. Hence, allowing multinational corporations to use foreign tax credits to offset the U.S. taxes they would otherwise owe on export income may be an inappropriate use of such credits.

REV-27 Make Foreign Subnational Taxes Deductible Rather Than Creditable

	Added Revenues (Billions of dollars)
2002	2.6
2003	5.5
2004	5.7
2005	6.0
2006	6.3
2002-2006	26.1
2002-2011	62.1

SOURCE: Joint Committee on Taxation.

RELATED CBO PUBLICATION:

Causes and Consequences of the Trade Deficit: An Overview (Memorandum), March 2000.

Under current law, U.S.-owned corporations deduct U.S. state and local income taxes from their taxable income. However, they receive tax credits—which provide more tax benefits than deductions—for income taxes that they pay to foreign governments, including foreign subnational governments such as foreign states, cities, and provinces. This option would treat income tax payments to foreign subnational governments on a par with payments to domestic state and local governments. That change would increase tax revenues by $2.6 billion in 2002 and $62.1 billion over the 2002-2011 period.

Specifically, this option would continue to allow corporations to receive a credit for foreign taxes provided those taxes exceeded a fixed percentage of either their foreign-source income or their foreign income taxes. That percentage would be set to reflect the overall ratio of state and local to federal income taxes within the United States. Taxes for which credits were denied would be deducted from a corporation's foreign-source gross income to yield its foreign-source taxable income. If policymakers chose to enact this option, they could structure it to either defer to or override existing tax treaties between the United States and foreign governments that call for other kinds of tax treatment.

Proponents of this option would probably argue that its main benefit would be to level the playing field between domestic and foreign investment. The option would accomplish that by reducing the slight incentive that U.S.-based multinational corporations now have to invest more abroad than at home, particularly in countries where the overall level of foreign income tax on a foreign investment is lower than the combined U.S. federal, state, and local taxes on a domestic investment. In turn, equalizing the tax treatment of foreign and domestic investment would allocate capital more efficiently worldwide.

In some cases, however, removing the creditability of income taxes paid to foreign subnational governments would have drawbacks. The option would make U.S. corporations operating in a foreign country less competitive with other foreign companies operating there and would probably lead some firms to repatriate less income from prior overseas investments to avoid paying the additional U.S. tax. Furthermore, if foreign countries implemented similar rules for taxing income that their corporations earned in the United States, those firms might curtail their U.S. investments, and the amount of capital flowing into the United States might decline.

REV-28-A Include Accrued Capital Gains in the Last Income Tax Return of Decedents

	Added Revenues (Billions of dollars)
2002	a
2003	11.6
2004	11.1
2005	10.6
2006	10.1
2002-2006	43.4
2002-2011	86.4

SOURCE: Joint Committee on Taxation.

a. Less than $50 million.

RELATED OPTIONS:

REV-04, REV-28-B, and REV-29

A capital gain or loss is the difference between the current value of a capital asset (such as corporate stock or a private business) and the owner's basis. The owner's basis is the initial cost of the asset plus the cost of any subsequent improvements and minus any deductions for depreciation. When capital assets are sold, tax law normally requires that the owners include in their taxable income any gains that they have realized on those assets minus any losses. If their gains do not exceed their losses, owners may deduct up to $3,000 of their net losses from other income.

An exception occurs when an owner holds an asset until death. In that case, tax law allows the inheritor to "step up" the basis to the asset's value on the date of the owner's death. That means that when the asset is sold, the inheritor pays income tax only on the gain that accrued after the owner's death; the gain that accrued before death is permanently excluded from taxable income. The estate of the decedent may pay taxes under the separate estate tax, but that tax applies equally to assets on which the decedent previously paid income tax and assets with accrued capital gains that escaped income taxation.

This option would tax accrued but unrealized gains on the final income tax return of a decedent, raising $86.4 billion from 2002 through 2011. That estimated increase in revenues assumes that the unified estate and gift tax continues in its current form and that any legislation to implement this option would include provisions for easing compliance and valuing assets. For example, to allow for inadequate recordkeeping by decedents on an asset's basis, the option would initially allow estates to set the basis of an asset at half of its current value. Provisions for valuing farms and small businesses could be adapted from the estate tax. Under this option, about 10 percent of decedents would owe taxes on accrued gains on their final return. (Canada has had a similar tax in place since 1972 but imposes no estate tax.)

Stepping up basis at death provides a tax break for capital gains that is not available for other income such as wages or interest. That tax advantage encourages people to hold assets until death, when they might have preferred to sell them earlier. Furthermore, stepping up basis at death has spawned many tax-sheltering schemes in which, for example, people borrow against their assets for current consumption but have the loan paid off by selling the assets after they die.

A disadvantage of taxing capital gains at death is that the tax might force the decedent's family to sell assets to pay the tax, which could substantially reduce the assets' value if the time was not optimal for such a sale. Forcing heirs to sell a family farm or business would impose a particular hardship on families wanting to continue the enterprise. Another disadvantage of taxing gains at death is that the decedent may have inadequately documented the asset's basis.

REV-28-B Enact Carryover Basis for Capital Gains Held Until Death

	Added Revenues (Billions of dollars)
2002	a
2003	1.2
2004	2.2
2005	3.4
2006	4.7
2002-2006	11.5
2002-2011	52.5

SOURCE: Joint Committee on Taxation.

a. Less than $50 million.

RELATED OPTIONS:

REV-04, REV-28-A, and REV-29

Carrying over a decedent's basis in an asset (known as carryover basis) is an alternative to requiring that any capital gains accrued on an asset held at the time of a person's death be included on the decedent's last income tax return (see option REV-28-A). Under this option, heirs would adopt the basis of the decedent on assets they inherited, and the decedent's capital gains would then be taxed when the heirs sold the assets. The option would raise $52.5 billion from 2002 through 2011, assuming that the estate and gift tax continued in its current form and that provisions were enacted to make it easier to value an asset and comply with the option. For example, to allow for a decedent's inadequate recordkeeping on an asset's basis, the option would initially allow heirs to set the basis of an inherited asset at 50 percent of the asset's value at the time they inherit it. Valuation provisions could follow those already used under the estate tax.

Using the carryover basis of an asset would avoid a major disadvantage of taxing gains on a decedent's final income tax return: the heirs would not be faced with a large tax bill that could force them to sell assets at an inopportune time. Carryover basis could also ease the way for a family seeking to continue to operate a decedent's business. But it would not resolve the problem of inadequate recordkeeping by a decedent, except to the extent that the 50 percent rule suggested above would provide a certain rough justice.

This option would achieve some of the objectives of option REV-28-A, which calls for taxing gains on the decedent's final tax return. This option would eventually tax most gains held at death, removing some of the inequity inherent in never taxing them. It would also encourage people to sell assets at opportune times instead of holding them, for tax purposes, until death. In addition, carryover basis would lessen the advantages of tax shelters that give people access to their investment funds before death without selling the asset outright until after it. Despite what it could accomplish, however, carryover basis would achieve less than would taxing gains at death, because it would still defer taxes for heirs who could afford to postpone selling inherited assets with large capital gains.

Although gains held until death have always been exempt from income tax, the Congress has twice enacted carryover basis. The Tax Reform Act of 1976 would have introduced it, but subsequent legislation postponed and then repealed it. The primary objection heard at the time of repeal was that recordkeeping by many owners of assets would be inadequate for their heirs to document basis. In 2000, the Congress enacted carryover basis in conjunction with repealing the estate tax. The new approach was to take effect in 2010, but the President vetoed the act. The legislation would have allowed basis to be stepped up for $1.3 million of assets passed to any heirs and $3 million passed to a spouse. (REV-28-A discusses stepping up basis.)

REV-29 Eliminate Like-Kind Exchanges

	Added Revenues (Billions of dollars)
2002	0.2
2003	1.1
2004	1.1
2005	1.2
2006	1.2
2002-2006	4.8
2002-2011	11.7

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-04, REV-28-A, and REV-28-B

The tax code requires that people who sell or exchange capital assets report any capital gain or loss as part of their taxable income. An exception is exchanges of certain similar assets, mainly real estate. The tax code recognizes no gain or loss if property held for productive use in a trade or business or for investment is exchanged for property of a "like kind" that is to be held for the same reasons. In those exchanges, people carry over to the new property any gain that has accrued on the old asset, and they do not pay tax on that gain until the new property is sold. Like-kind real estate assets are broadly defined as any properties located in the United States.

In some exchanges, two owners swap like-kind property, but in many instances, a single owner sells one property to a second party and purchases a replacement property from a third. For those transactions to qualify as like-kind exchanges, the proceeds from the sale of the original property must be held outside the seller's control—for example, by a qualified intermediary—and used to purchase the replacement property. In addition, the like-kind replacement property must be identified within 45 days and purchased within 180 days.

By deferring taxation, the tax code treats capital gains from like-kind exchanges more favorably than gains made in trading many other assets. Any gain from selling one stock to purchase another, for example, or from selling a share in one partnership to purchase another is taxable in the year of the exchange. Gains from trades of bonds, mortgages, and other debt instruments are similarly taxed. Eliminating the deferral for like-kind exchanges would make the tax system more equitable and raise $11.7 billion from 2002 to 2011.

An argument that is sometimes used to justify continuing like-kind exchanges is that the new property is a continuation of the same investment as the previous one and no tax should be levied until the owner leaves that line of investing. Also, when owners simply swap property, without cash changing hands, no money becomes available for paying the tax. Furthermore, allowing like-kind exchanges helps property owners respond more easily to changing conditions in their lives or in property markets. But those justifications apply as well to many exchanges of stocks, bonds, and partnership shares and therefore do not support treating real estate and certain other exchanges differently from exchanges of assets such as stocks and bonds. One reason for either continuing the current differential treatment or phasing it out slowly is that many investors purchased property with the understanding that they would be able to exchange it for other property without paying capital gains taxes. Changing the tax treatment abruptly would impose hardships on some investors and could depress property prices. Finally, like-kind exchanges are not the only such transactions that receive deferrals: the tax code permits some tax-deferred swaps of corporate equities, such as those that take place in business mergers.

In the past, the Congress has considered limiting the amount of gain that owners can defer under like-kind exchanges of real property. Proposals have also been made to defer gains only on exchanges of properties that are related or similar in service or use. Although that stricter standard already applies to gains on certain involuntary conversions, applying it on a broader scale would be difficult.

REV-30 Include Life Insurance Proceeds in the Base for Estate Taxes

	Added Revenues (Billions of dollars)
2002	0
2003	0.5
2004	0.5
2005	0.5
2006	0.5
2002-2006	2.0
2002-2011	4.9

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-31

The tax code includes a gift tax that is levied on transfers of wealth during a taxpayer's lifetime and an estate tax imposed on such transfers when a person dies. The two taxes together constitute a unified, progressive tax, combining the taxation of assets given away during a person's life and his or her bequests made at death. Credits built into the system have always excluded most of those transfers from taxation, so that less than 2 percent of deaths result in an estate tax filing. The Taxpayer Relief Act of 1997 increased the unified credit for the first time since the late 1980s to prevent the number of estates subject to tax from rising and to lower the taxes paid by taxable estates.

One method for transferring wealth gets preferential treatment under the estate tax: payouts on life insurance policies are not counted as transferred wealth if the owner of the policy is not the decedent. (The U.S. tax code and regulations of the Internal Revenue Service define the owner of a life insurance policy.) Thus, one important element of estate tax planning during a wealthy taxpayer's lifetime is to make the payments on life insurance policies, with the intended heirs as the beneficiaries, directly or through trust arrangements. The premiums are not taxed as gifts as long as they total less than $10,000—the amount that each donor can give to each recipient annually without incurring tax on the gift. This option would include the proceeds from life insurance policies in the base on which estate taxes are calculated, raising about $4.9 billion between 2002 and 2011.

The way the tax code treats proceeds from life insurance has varied over the years. The modern estate and gift tax system was put into place in 1916. Legislation enacted in 1918 included life insurance proceeds in the base for figuring estate taxes; the act covered proceeds from policies owned by the decedent and payouts in excess of $40,000 from policies owned by others. In 1942, all proceeds from policies owned by the decedent or for which the decedent paid the premiums were made taxable. But in 1954, the Congress dropped the "premiums paid" test, leading to the current system in which only policies owned by the decedent are included in the estate tax base.

That system offers a significant tax benefit to the insured taxpayer during his or her lifetime if the policy provides whole-life rather than term insurance. The initial payment of premiums does not affect the donor's tax liability because those amounts can be transferred tax-free, for any reason, under the annual $10,000 exclusion. The real benefit comes later, as premiums invested in whole-life plans earn interest and dividends that are not subject to income tax.

Another benefit gained by excluding life insurance from the base for estate taxes is that it lowers the cost of transferring wealth when assets are not liquid. For example, the owner of a closely held business (typically, a small business or farm with only one or a few owners) can acquire life insurance to "prepay" the estate tax that will be liable on the business; in that way, the heirs can avoid having to sell the business to pay the taxes. This option would increase the cost of that practice.

REV-31 Eliminate Nonbusiness Valuation Discounts Under the Estate Tax

	Added Revenues (Billions of dollars)
2002	0
2003	0.7
2004	0.7
2005	0.7
2006	0.8
2002-2006	2.9
2002-2011	7.6

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-30

Current law imposes a gift tax on transfers of wealth during a taxpayer's lifetime and an estate tax on such transfers at death (see option REV-30 for more details). To reduce gift tax liabilities, some taxpayers use an accounting practice that artificially reduces the value of the taxable estate by transferring marketable securities, such as stocks and bonds, to holding companies, which then issue shares (claims to the securities) to the taxpayer's intended heirs. The transferred assets are still taxable when the time comes to compute the taxable estate. But in many instances, those assets are not taxed at their full value. Instead, they are discounted under a common practice applied to minority holdings in businesses that are not publicly traded. (Basically, minority holdings are those representing less than a 50 percent interest.)

The practice of discounting derives from the goal of the estate tax system that seeks to tax only the value of a business's asset that a buyer would be willing to pay. Advocates of discounting justify it on the grounds that a buyer who purchased a minority share in an ongoing business operation would generally pay less than the market value for it because the shareholder or shareholders who had a majority share could adversely affect the long-term value of the minority owner's share. (For example, if the majority owners were also officers of the company, they could, in theory, make decisions that would increase their income at the expense of minority owners' income.)

The use of such a practice for nonbusiness assets, however, is difficult to defend on the same basis. In nonbusiness situations, a taxpayer typically contributes marketable assets (such as cash, foreign currency, publicly traded securities, real property, annuities, or non-income-producing property including art or collectibles) to a family limited partnership or limited liability company and simultaneously gives or bequeaths minority interests in that holding company to his or her intended heirs. The taxpayer then claims discounts on those gifts, using the guidelines generally agreed on for transferring business assets. In short, the taxpayer claims a reduced value for the marketable asset simply because it was placed in a holding company before being given or bequeathed.

This option would restrict the practice of valuation discounts to active businesses, raising revenues by $7.6 billion over the 2002-2011 period. For holdings in a nonbusiness entity, the specific option would require that their value be determined as a proportional share of the fair market value of the entity's net worth (provided that its net worth included assets that were readily marketable when given or bequeathed). If the entity was part of an active business, that portion of its net worth that was held in marketable securities and used as working capital would be subject to the usual business valuation practices.

REV-32 Eliminate Private-Purpose Tax-Exempt Bonds

	Added Revenues (Billions of dollars)
2002	0.2
2003	0.7
2004	1.1
2005	1.6
2006	2.0
2002-2006	5.6
2002-2011	21.0

SOURCE: Joint Committee on Taxation.

Tax law permits state and local governments to issue bonds whose interest income is exempt from federal taxation—which allows those bonds to bear lower interest rates than taxable bonds. (The exemption essentially provides a subsidy to those governments by lowering the amount of interest they must pay to borrow the money.) For the most part, the bonds' proceeds finance public investments such as schools, highways, and water and sewer systems. But state and local governments also issue tax-exempt securities known as private-purpose bonds, whose proceeds are used by nongovernmental entities to finance quasi-public facilities and private-sector projects that include mortgages for rental housing and single-family homes; facilities such as airports, docks, wharves, mass transit, and solid waste disposal; small manufacturing facilities and agricultural land and property for first-time farmers; student loans; and facilities for nonprofit institutions, such as hospitals and universities.

The Congress has restricted tax-exempt financing for private purposes on several occasions, beginning in 1968. In the Tax Reform Act of 1986, legislators made the interest earned on newly issued private-purpose bonds taxable by including it in the base for the alternative minimum tax. In addition, they placed a limit on the volume of new bond issues by all governmental units within a state for exempt facilities, small manufacturing facilities, student loans, and housing and redevelopment. The current cap on state volume is the greater of $50 per resident or $150 million per calendar year. The limit in 2003 will be the greater of $55 per capita or $165 million; it will rise in increments of $5 and $15 million, reaching $75 per capita or $225 million in 2007. Bonds for some private activities are exempt from the limits; among such activities are airports, ports, and solid waste disposal facilities that meet requirements for government ownership, and certain bonds for nonprofit 501(c)(3) organizations (primarily hospitals and educational institutions).

This option would eliminate the tax exemption for all new issues of private-purpose bonds, increasing revenues by about $21 billion over the 2002-2011 period. That change would force the projects that would otherwise be financed with such bonds to borrow at the private market rate. Provided that most of the projects' benefits accrued to private individuals, the change in financing would allocate resources more efficiently.

Although private-purpose bonds subsidize activities that may merit federal support, tax-exempt financing is not the most efficient way to provide such help. With tax-exempt financing, the borrower (in this case, the nongovernmental entity) shares the benefit with investors in the bonds; with a direct subsidy, the benefit would go entirely to the borrower. Another drawback to tax-exempt financing is that, unlike a budget outlay, it does not receive regular scrutiny by policymakers in the annual budget process.

Rather than eliminating the tax exemption for private-purpose bonds, policymakers could control their volume. An alternative option would limit the volume of all bonds for private nonprofit and quasi-public facilities and eliminate the increases in the volume cap that are scheduled to begin in 2003. Those changes would boost revenues by $11.8 billion in 2002 through 2011; they would also curb the growth of all private-purpose bonds without sharply reducing their use. The curb would primarily affect bond issues for nonprofit organizations, which are not included under the current cap. The option would also apply to bonds for airport facilities, such as departure gates, that are for the exclusive private use of airlines under long-term leases. However, the option would continue to allow unlimited tax-exempt financing of facilities such as runways and control towers at government-owned airports.

REV-33 Reduce Tax Credits for Rehabilitating Buildings and Repeal the Credit for Nonhistoric Structures

	Added Revenues (Billions of dollars)
2002	0.2
2003	0.2
2004	0.2
2005	0.2
2006	0.2
2002-2006	1.0
2002-2011	2.0

SOURCE: Joint Committee on Taxation.

The Congress has enacted tax credits for rehabilitation to induce people to preserve historic buildings, prompt businesses to renovate their existing premises rather than relocate, and encourage investors to refurbish older buildings. The credit is 10 percent of expenditures on commercial buildings built before 1936 and 20 percent of expenditures on commercial and residential buildings that the Department of the Interior has certified as historic structures because of their architectural significance. This option would reduce the credit for historic structures to 15 percent and repeal the credit for nonhistoric structures, which would increase revenues over the 2002-2011 period by about $2 billion. Repealing both credits would raise about $4.1 billion over the same period.

Proponents and opponents of this option could mount several arguments to support their positions. On the one hand, proponents might say, the credits favor commercial structures over most rental housing and may therefore distort the allocation of capital. Moreover, in favoring renovation over new construction, the credits may encourage more costly ways of obtaining additional housing and commercial buildings. On the other hand, the option's opponents might contend, rehabilitation may have social benefits when it discourages people from destroying historically noteworthy buildings. The government could promote that objective at a lower cost, however, by permitting a credit only for renovating certified historic buildings and by lowering the credit's rate. Some surveys indicate that a credit of 15 percent would be sufficient to cover the extra costs involved in undertaking a rehabilitation that satisfied regulatory standards for historic preservation.

REV-34-A Tax Credit Unions Like Other Thrift Institutions

	Added Revenues (Billions of dollars)
2002	0.5
2003	0.8
2004	0.8
2005	0.8
2006	0.9
2002-2006	3.8
2002-2011	8.8

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-34-B

Thrift institutions—which include savings and loan associations, mutual savings banks, and credit unions—are financial organizations that primarily accept deposits from and make loans to individuals. Originally, all such institutions were nonprofits—and thus exempt from income taxes—but in 1951, the Congress eliminated the tax exemptions for savings and loans and mutual savings banks because it considered them to be similar to profit-seeking corporations. In contrast, the earnings of credit unions have remained tax-free. This option would tax credit unions like other thrift institutions, raising $8.8 billion from 2002 through 2011.

Credit unions provide many of the same services that other thrift institutions offer, including car loans, direct deposit, access to automatic tellers, preauthorized payments, credit cards, individual retirement accounts, safe deposit boxes, and discount brokerage services. Some large credit unions also offer electronic access to accounts as well as business loans. Another point of similarity is that many credit unions, like the other thrifts, have retained earnings (the portion of their net income that credit unions reserve instead of paying out in dividends to members). Credit unions contend that such earnings protect them against unexpected events; other thrift institutions complain that credit unions use the earnings to expand their operations.

Credit unions also resemble the other thrifts in that they no longer limit their membership. Originally, credit unions were designed to be cooperatives whose members shared the common bond of the same employer or occupation. Since 1982, however, regulators have allowed credit unions to extend their services to members of other organizations. Although that practice was challenged in the courts, recent legislation (the Credit Union Membership Access Act of 1998) allows multiple, unrelated groups to join the same credit union as long as each group has 3,000 or fewer members when it joins. In addition, most credit unions allow members and their families to participate permanently, even after members have left the sponsoring organization. Today, about 70 million people are members of credit unions, up from about 5 million in 1950.

Proponents of this option contend that credit unions are now quite similar to the other thrift institutions and should receive similar tax treatment. Treating all of the thrifts similarly under the tax code would encourage them to compete and provide services at the lowest cost, thereby increasing efficiency. Nevertheless, small credit unions are still more like nonprofit mutual organizations than, for example, like savings and loans, and taxing them like the other thrift institutions could be inappropriate. (See REV-34-B for an alternative option that would allow small credit unions to retain the exemption on earnings.)

REV-34-B Tax Large Credit Unions Like Other Thrift Institutions

	Added Revenues (Billions of dollars)
2002	0.4
2003	0.7
2004	0.7
2005	0.7
2006	0.8
2002-2006	3.3
2002-2011	7.7

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-34-A

An alternative to taxing all credit unions like other thrift institutions (see option REV-34-A) would be to tax only the earnings of large credit unions and allow those of small ones to remain tax-exempt. For example, the Congress could choose to tax only credit unions with assets of more than $10 million. Such an action would exempt approximately 8 percent of all assets in the credit union industry but about two-thirds of all credit unions. The option would raise $7.7 billion from 2002 to 2011.

Small credit unions, unlike large ones, are more similar to nonprofit mutual organizations, whose earnings are thus tax-exempt. The similarities between the two kinds of organizations argue for treating them the same way under the tax code. Like other nonprofit mutual organizations, most small credit unions have members with a single common bond or association. In some cases, volunteers from the membership manage and staff the credit union. Moreover, many small credit unions do not provide services comparable with those of other thrift institutions. The option is not without drawbacks, however. One difficulty in taxing large credit unions but allowing small ones to remain tax-exempt is that using $10 million in assets as a cut-off is somewhat arbitrary.

REV-35 Repeal the Expensing of Exploration and Development Costs for Extractive Industries

	Added Revenues (Billions of dollars)
2002	2.2
2003	3.0
2004	2.4
2005	1.7
2006	1.0
2002-2006	10.3
2002-2011	12.4

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

300-07, REV-36, REV-37, REV-39, and REV-44

RELATED CBO PUBLICATION:

Reforming the Federal Royalty Program for Oil and Gas (Paper), November 2000.

Through various tax preferences, the current tax system treats extractive industries (producers of oil, gas, and minerals) more favorably than most other industries (see option REV-36). One preference allows certain types of oil and gas producers and producers of hard minerals to "expense" some of their exploration and development costs—that is, to deduct those costs from their taxable income when they are incurred, rather than over time, as the resulting income is generated, a process known as capitalizing costs. Eliminating the expensing of those costs would raise $12.4 billion from 2002 through 2011. (The option assumes that firms could still expense some of their costs, specifically those from unproductive wells and mines.)

Immediately deducting costs contrasts with the tax treatment that other industries face, in which costs are deducted more slowly, according to prescribed rates of depreciation or depletion. The Tax Reform Act of 1986 established uniform capitalization rules that require certain direct and indirect costs related to property to be either deducted when the property is sold or recovered over several years as depreciation. (In both cases, the deducting of costs is postponed.) However, so-called intangible costs (for example, maintaining working capital) related to drilling and development and costs for mine development and exploration are exempt from those rules. Thus, the expensing of such costs leads to a tax preference for extractive industries that other industries do not have. (See options REV-37, REV-39, and REV-44 for other exceptions.)

Costs for exploration and development that extractive firms can expense include costs for excavating mines, drilling wells, and prospecting for hard minerals—but not for oil and gas. Although current law allows independent oil and gas producers and noncorporate mineral producers to fully expense their costs, it limits expensing to 70 percent of costs for "integrated" oil and gas producers (companies involved in substantial retailing or refining activities) and corporate mineral producers. Firms subject to the 70 percent limit must deduct the remaining 30 percent of their costs over 60 months.

The rationale for expensing the costs of exploration and development has shifted from its original focus. When the provision was put into place, the argument was that such costs were ordinary operating expenses. Today, advocates of continuing the preference justify it on the grounds that oil and gas are "strategic minerals," essential to national energy security. But expensing works in several ways to distort the allocation of resources. First, it causes resources to be allocated to drilling and mining that might be used more productively elsewhere in the economy. Second, although the preference might make the United States less dependent on imported oil in the short run, it encourages producers to extract more now—perhaps at the cost of extracting less in the future and relying more on foreign production. Third, expensing may result in production being allocated inefficiently within these extractive industries. Inefficiency may occur because the extent of the subsidy that the preference essentially provides depends on factors that are not systematically related to economic productivity—such as the difference between the immediate deduction and the true useful life of the capital—as well as on whether the producer must pay the alternative minimum tax (in which case expensing is limited).

REV-36 Repeal Percentage Depletion for Extractive Industries

	Added Revenues (Billions of dollars)
2002	0.3
2003	0.3
2004	0.3
2005	0.3
2006	0.3
2002-2006	1.5
2002-2011	3.0

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

300-07, REV-35, and REV-37

RELATED CBO PUBLICATION:

Reforming the Federal Royalty Program for Oil and Gas (Paper), November 2000.

The current tax system in various ways favors extractive industries (producers of oil, gas, and minerals) over most other industries. One way is by allowing producers to deduct immediately, rather than over time, the costs they incur for exploration and development (see option REV-35). Another is by allowing some firms to use the "percentage depletion" method to recover their costs rather than the standard "cost depletion" method. This option would repeal percentage depletion and raise about $3 billion over the 2002-2011 period.

The percentage depletion method of cost recovery is a tax preference given to certain types of extractive companies (independent producers, owners of royalties, and "nonintegrated" firms—companies that are not involved in substantial retailing or refining activities). The tax code allows those firms to deduct from their taxable income a certain percentage of a property's gross income in each taxable year, regardless of the actual capitalized costs (that is, the deduction that should occur over time). In contrast, other industries (and, since 1975, integrated oil companies as well) use the cost depletion method. Under cost depletion, the costs that a firm recovers cannot exceed its expenses for acquiring and developing the property; under percentage depletion, they may. Thus, the percentage depletion method treats certain types of extractive companies more favorably than others. Unlike the expensing of exploration and development costs, however, percentage depletion applies only to a small subset of total oil, gas, and minerals production because it excludes the large integrated producers.

Current law typically allows nonintegrated oil and gas companies to deduct 15 percent of their gross income from producing oil and gas, up to a ceiling of 1,000 barrels per day. But the Omnibus Budget Reconciliation Act of 1990 made percentage depletion even more generous for nonintegrated companies that are considered "marginal" producers (those with very low total production or production entirely made up of heavy oil). The deduction for marginal properties can be up to 25 percent of gross income if the price of oil drops low enough. Producers of hard minerals may also use percentage depletion, but the statutory percentages vary from 5 percent to 22 percent, depending on the type of mineral. Tax law limits the amount of percentage depletion to 100 percent of the net income from a property with oil and gas and 50 percent of the net income from a property with hard minerals.

Percentage depletion has been justified on the grounds that oil and gas are "strategic minerals," essential to national energy security. But that method of recovering costs distorts the allocation of resources by encouraging more production in the oil and gas industry than among other types of firms. And, like expensing, percentage depletion can cause extractive businesses to allocate their resources inefficiently—for example, by developing existing properties rather than exploring for and acquiring new ones.

REV-37 Repeal the Tax Credit for Enhanced Oil Recovery Costs and Expensing of Tertiary Injectants

	Added Revenues (Billions of dollars)
2002	0.1
2003	0.1
2004	0.1
2005	0.1
2006	0.1
2002-2006	0.5
2002-2011	1.5

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-35, REV-36, REV-39, and REV-44

RELATED CBO PUBLICATION:

Climate Change and the Federal Budget (Memorandum), August 1998.

Oil producers currently receive a tax credit of 15 percent against their costs for recovering domestic oil by a qualified "enhanced oil recovery" (EOR) method. Qualifying methods are those that allow producers to recover oil that is too viscous to be extracted by conventional methods. The costs of labor, materials, equipment, repairs, intangible drilling, and development qualify for the credit, which phases out when oil prices rise above $28 per barrel (adjusted for inflation).

The tax code also provides another preference related to viscous oil. It allows producers to "expense" the costs of tertiary injectants—the fluids, gases, and other chemicals that are injected into oil or gas reservoirs to extract highly viscous oil. Producers may deduct the full cost of those chemical injectants in the year in which they are used to extract oil. The expenditures for injectants also qualify for the EOR credit; however, the credit must be subtracted from the deduction if both are claimed for the same expenditure. Eliminating both the EOR credit and the expensing of tertiary injectants would increase revenues by $1.5 billion over the 2002-2011 period.

The Congress enacted the EOR credit as part of the Omnibus Budget Reconciliation Act of 1990. It was intended to increase the domestic supply of oil and reduce the demand for imported oil, particularly from producers in the Persian Gulf and other politically unstable areas. Legislators enacted the expensing of tertiary injectants in 1980 for similar reasons. However, without the incentives provided by the credit and expensing (both of which are essentially subsidies from the federal government), the use of tertiary injectants to extract oil would not be economical, and EOR would not be a realistic extraction approach (because it is more expensive than recovering oil by conventional methods).

Both provisions offer capital subsidies that their advocates say provide several benefits. The subsidies lower the cost of producing oil by unconventional, more-expensive methods, and they enable producers to increase the extractable portion of a reservoir's oil beyond the normal one-third to one-half. Increased domestic production lessens short-term dependence on foreign oil, but it also depletes domestic resources, encouraging long-term dependence on imports. Indeed, opponents of subsidies argue that these provisions are unlikely to reverse the long-term slide that has occurred in domestic production and the nation's growing dependence on imports. They also contend that the subsidies are no longer needed. The United States is now less vulnerable to disruptions in supply because it stockpiles oil in the Strategic Petroleum Reserve and because world oil markets have become increasingly competitive.

REV-38 Repeal the Partial Exemption from Motor Fuel Excise Taxes Now Given to Alcohol Fuels

	Added Revenues (Billions of dollars)
2002	0.5
2003	0.6
2004	0.6
2005	0.6
2006	0.6
2002-2006	2.9
2002-2011	6.4

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

270-01, 270-03, 270-08, and REV-51

The tax code imposes excise taxes on motor fuels, but it partially exempts fuels that are blends of gasoline and alcohol. Repealing that partial exemption would raise $6.4 billion in revenues over the 2002-2011 period. The estimate assumes that the Congress would also repeal the alcohol fuels credit, an alternative tax benefit that can be used instead of the partial excise tax exemption. The credit, however, is in almost all cases less valuable than the exemption and is rarely used.

The tax benefit from the exemption applies only to blends that use alcohol fuels produced from nonfossil, or renewable, sources. One such fuel is ethanol, which is produced primarily from corn and sugar. When used as a fuel, ethanol is eligible for a nonrefundable tax benefit—through the credit or the exemption—of up to 54 cents per gallon. The magnitude of the benefit depends on the percentage of alcohol in the fuel. For example, gasohol, which is 90 percent gasoline and 10 percent ethanol, receives an exemption of 5.4 cents per gallon from the excise tax on gasoline of 18.3 cents per gallon. (The tax benefit goes to the firm that blends the ethanol with the gasoline.) The benefit was first enacted in the 1970s and was scheduled to expire at the end of fiscal year 1999. But the Transportation Equity Act of 1998 extended it while gradually lowering the maximum amount. Thus, the exemption drops to 5.3 cents per gallon for 2001 to 2002, 5.2 cents per gallon for 2003 to 2004, and 5.1 cents per gallon for 2005 to 2007. The entire exemption is now scheduled to expire at the end of fiscal year 2007.

The tax benefit had several main purposes when it was first enacted. One was to bolster national security by reducing the demand for imported oil, thereby lessening U.S. dependence on foreign sources. Another was to provide an additional market for U.S. agricultural products by encouraging firms to produce ethanol domestically. Judging by sales of the motor fuel blends, the tax benefit appears to have successfully encouraged energy producers to substitute ethanol for gasoline.

Today, supporters of the benefit argue, the major justification for it is that using oxygenated fuels in motor vehicles generally produces less carbon monoxide pollution than using gasoline. Those proponents might also point to the effect that repealing the benefit could have on federal outlays for price support loans for grains. Without the benefit's incentive to produce corn for ethanol, the price of corn might fall, which could lead the government to step in to help farmers. But any increase in outlays for price support loans, which is not included in the budget estimates shown above, would probably be much smaller than the projected boost in revenues.

Regulations now in place under the Clean Air Act Amendments of 1990, mandating the minimum oxygen content of gasoline used in areas with poor air quality, raise questions about the continued need for the benefit. Recent actions by the Environmental Protection Agency to restrict the use in gasoline of MTBE (an alcohol fuel derived from fossil fuel sources) further support the use of ethanol to meet the standards for oxygen content. Another argument for repealing the exemption involves resource allocation. It takes more resources to produce ethanol than to produce gasoline. The resource allocation that results from the partial exemption may be economically inefficient if the value of those resources in alternative uses outweighs the value of the reduction in air pollution.

REV-39 Capitalize the Costs of Producing Timber

	Added Revenues (Billions of dollars)
2002	0.4
2003	0.6
2004	0.5
2005	0.5
2006	0.5
2002-2006	2.5
2002-2011	4.7

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

300-01, REV-35, REV-37, and REV-44

The current tax system allows timber producers to deduct, or "expense," most of the costs of maintaining a stand of timber when those costs are incurred. (Such expenses include disease and pest control, brush clearing, and indirect carrying costs such as interest on loans and property taxes.) That tax treatment contrasts with the uniform capitalization rules that apply to such costs in most other industries. (See options REV-35, REV-37, and REV-44 for other exceptions.) Established under the Tax Reform Act of 1986 (TRA-86), the uniform capitalization rules require that production costs not be deducted until goods or services are sold. When businesses are allowed to expense those costs, the effective tax rate on a producer's investment in them is zero. Thus, timber producers pay no tax on any income they use to cover those costs, and the tax code in effect subsidizes timber production by deferring taxes that producers otherwise would owe on their income. (Under certain circumstances, however, the tax code's limits on losses from passive business activities may greatly curtail the deferral granted to noncorporate producers of timber.) This option would capitalize costs incurred after December 31, 1999, for producing timber; it would raise $4.7 billion in revenues from 2002 through 2011 by accelerating tax payments from timber producers.

Various rationales have been offered for expensing the costs of timber production. The original justification was a general perception that such costs were for maintenance and thus deductible as ordinary costs of a trade or business. When TRA-86 established uniform capitalization rules for other industries, one reason given for exempting timber was that applying the rules to that industry might have been unduly burdensome. But the exemption comes with an economic price. The subsidy from expensing the costs of timber production distorts investing in two ways: more private land is devoted to timber production than might otherwise have been the case, and trees are allowed to grow longer before they are cut (because producers do not have to harvest them quickly to finance their costs). Those outcomes could be considered beneficial if timber growing offered spillover benefits to society that market prices did not take into account. Otherwise, the tax preference would lead to inefficiency in both the use of land and rate of harvesting.

Whether or not timber production offers important spillover benefits is unclear. Standing timber provides some benefits by deterring soil erosion and absorbing carbon dioxide (a gas linked to global warming), but timber cutting can lead to soil erosion. In addition, producing and disposing of wood and paper products contribute to pollution.

In the short run, capitalizing the costs of timber production might lower the price of domestic timber because producers would have an incentive to harvest earlier. In the longer run, however, it would raise prices and lower the value of the land used to grow timber. Moreover, lease payments to private landowners by timber growers would probably decline, causing some land that historically has been devoted to growing timber to be used in other ways.

REV-40 Tax the Income Earned by Public Electric Power Facilities

	Added Revenues (Billions of dollars)
2002	0.4
2003	0.7
2004	0.7
2005	0.7
2006	0.7
2002-2006	3.2
2002-2011	7.2

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

270-05, 270-06, 270-07, 270-11, REV-45, and REV-46

The income that local governments earn from any public utility, including electric power facilities, is exempt from federal income tax. In contrast, the income of investor-owned utilities is taxable. Taxing the income of public facilities for generating, transmitting, and distributing electricity similarly to the income of investor-owned facilities would raise $7.2 billion from 2002 through 2011.

In the past, electricity was provided by local monopolies, in part to take advantage of cost-saving economies of scale. Some of those utilities were public facilities, which developed for a variety of reasons. For example, public facilities offered a feasible alternative in geographic areas where low population density caused the cost of power per customer to be high and private producers were reluctant to enter a market in which the potential for profit appeared inadequate. Public utilities also developed in areas where citizens worried that a private provider might exploit its position as a monopoly and wanted to ensure that electricity would be available to all residential consumers at a reasonable cost.

But times and circumstances change. States have begun to deregulate electric power generation, in part because improved technologies have lessened the importance of economies of scale and in part because electric service is almost universal in this country, even in areas of low population density. And the competition that the industry's restructuring brings, say advocates of this option, will protect consumers from monopolistic pricing by private firms.

One argument for exempting public power's income from taxation has been that it is a way to keep the price of power low and thus subsidize the power costs of lower-income people. But preferential tax treatment is an inefficient way of accomplishing that. The federal government could help lower-income groups—with less revenue loss and less impact on the expected gains to the economy from restructuring—by expanding aid that is already available, specifically the Low Income Home Energy Assistance Program of grants to the states.

Proponents of this option would contend that economic and technological changes, combined with the fact that approximately 75 percent of electric power is already provided by the private sector, cast doubt on the benefits society receives from public-sector involvement in this market. Even less clear are the benefits that federal taxpayers receive from treating the earnings of public providers of electricity more favorably than the earnings of private providers. Proponents contend that taxing publicly owned electric facilities will spur competition. It will also cause the economically efficient amount of public power to be consumed and preserve the corporate tax base.

At the same time, taxing the income of public electric utilities might adversely affect consumers in some communities who rely on that source for their power. The tax would cause the price of publicly provided electricity to rise, and public utilities that found themselves uncompetitive without the subsidy might have to shut down some facilities that were inefficient. If those facilities were being financed with debt that had not yet been retired, taxpayers could be left with significant costs. Further complicating a change such as the one described in this option are the numerous legal and practical issues that would have to be resolved if the federal government taxed income earned from what might be termed business enterprises of state and local governments.

REV-41 Replace the Income Tax Credit with a Business Deduction for Employer FICA on Certain Tip Income

	Added Revenues (Billions of dollars)
2002	0.2
2003	0.3
2004	0.3
2005	0.3
2006	0.3
2002-2006	1.4
2002-2011	2.9

SOURCE: Joint Committee on Taxation.

Employers in the food and beverage industry are entitled to a nonrefundable credit, applied against their income tax liability, for the taxes they pay on employee tips under the Federal Insurance Contributions Act, or FICA. (FICA is the law underlying the payroll tax that funds Social Security.) However, any amount of tips that makes up the difference between an employee's regular wages and the minimum wage is excluded from the credit. This option would replace the credit with a business deduction, the tax code's standard treatment for such labor costs. It would increase revenues by $2.9 billion from 2002 through 2011.

How the tax code treats employers' taxes on tips has changed several times over the past decade or so. Before 1988, an employer was required to pay FICA tax on tips only in certain circumstances: if the federal minimum wage exceeded the wage the employer was paying, the employer paid tax on tips equaling the difference between the two wages. However, the Omnibus Budget Reconciliation Act of 1987 expanded the definition of wages subject to FICA tax to include all cash tips, which prompted opponents of that expansion to develop proposals for repealing the provision. For example, the Revenue Act of 1992 would have kept the expanded definition for FICA purposes but would have granted a full, nonrefundable credit against the new FICA tax as part of the general business credit. Legislators used that indirect approach because Congressional budget rules make it particularly difficult to lower Social Security revenues. The bill never became law; however, a similar provision was enacted as part of the Omnibus Budget Reconciliation Act of 1993. In that case, the credit applied only to tips received at establishments serving food and beverages. The Small Business Job Protection Act of 1996 expanded the credit to tips received in connection with food served for takeout or delivered off premises.

Proponents of replacing the credit with a deduction cite several arguments. They maintain that the credit treats a specific industry (food service) and a specific form of compensation (tips) preferentially, encouraging employment in one sector of the economy at the expense of other, potentially more productive sectors. In contrast, proponents of the credit assert that tips differ from wages since they are paid by customers, not employers. From an economic perspective, however, tips are the same as wages because employees earn them for services performed. Tips could be considered self-employment income, but treating them that way would greatly increase the administrative burden of tax collection.

Advocates of retaining the credit contend that it may make the overall tax system more progressive. A credit reduces the tax burden of firms more than does a deduction. If the money a firm saves on taxes is passed on to low-wage earners—and the wages of waiters and waitresses are much lower than those of most employees—then progressivity would, indeed, be increased. However, firms might instead pass their savings on to customers, shareholders, or higher-paid employees—which would have little effect on progressivity.

REV-42 Tighten Rules on Interest Deductions for Corporate-Owned Life Insurance

	Added Revenues (Billions of dollars)
2002	0.3
2003	0.4
2004	0.4
2005	0.5
2006	0.5
2002-2006	2.1
2002-2011	4.9

SOURCE: Joint Committee on Taxation.

Corporations purchase life insurance policies in part to protect firms against financial loss in case one or more of their important employees or owners dies. Purchases of life insurance that builds up a cash value provide a tax benefit if corporations pay the premiums on the policies indirectly (by increasing debt or other liabilities) and then deduct the interest they pay on that debt from their taxable income. The Internal Revenue Service will not allow corporations to deduct that interest if it can link a firm's increases in debt or other liabilities directly to its purchase of cash-value insurance. Establishing a direct connection is difficult, however, because firms increase their liabilities for many purposes.

This option would disallow a proportion of a firm's total deductions for interest equal to the proportion of its total assets invested in cash-value life insurance policies. The option would not apply to insurance on the life of owners who had an interest of 20 percent or more in the firm. It would raise an estimated $4.9 billion over the 2002-2011 period.

The tax code's asymmetrical treatment of the investment income a corporation receives from life insurance policies and its costs in relation to those policies is the source of the tax benefit. First, tax law exempts the investment income (termed the "inside buildup") of a life insurance policy from corporate income tax. Second, it permits a corporation to deduct from its taxable income the interest on debt that is indirectly used to finance that investment. Such an approach opens the door to tax arbitrage (broadly, gaining advantage from asymmetrical treatment of gains and losses in the tax code) because corporations can generate interest deductions that they can then use to shelter other taxable income. Individual taxpayers may not gain that benefit because the tax code does not allow them to deduct those interest payments.

Over the past several years, the Congress has acted to keep corporations from using life insurance policies to shelter income. In 1996, it prohibited corporations from deducting the interest on loans from an insurance company that used the cash-value policy as collateral. (It made an exception, however, for insurance on certain key employees.) In 1997, the Congress enacted a law that disallowed a proportion of a corporation's interest deductions, but the law applied only to firms that purchased cash-value insurance on the lives of people who were not employees or owners. This option would further prohibit such deductions except for purchases of insurance on the lives of people who own at least 20 percent of the firm. The Clinton Administration included that alternative in its budgetary proposals for fiscal years 1999 through 2001. (This kind of disallowance has been used in other contexts as well. In 1986, the Congress disallowed a proportion of interest deductions for financial institutions that purchase debt issued by state and local governments whose interest is tax-exempt.)

Opponents of this option argue that a firm may have legitimate business reasons to purchase life insurance policies on its employees and owners as well as other business reasons to issue debt, and that the firm may not be linking the two decisions to create a tax shelter. Proponents of the option argue, however, that firms in most cases intend to use the policies and debt to shelter income from taxation.

REV-43 Repeal Tax-Free Conversions of Large C Corporations to S Corporations

	Added Revenues (Billions of dollars)
2002	a
2003	a
2004	0.1
2005	0.1
2006	0.1
2002-2006	0.3
2002-2011	0.8

SOURCE: Joint Committee on Taxation.

a. Less than $50 million.

For tax purposes, the predominant forms of business enterprise are C corporations, S corporations, partnerships, and sole proprietorships. Under current law, a C corporation may reduce taxes on some of its income by electing to be treated as an S corporation or by converting to a partnership. The income of C corporations faces a two-tiered corporate tax; that is, it is generally taxed twice—once when it is earned by the corporation and again when it is distributed to stockholders. Income received by S corporations and partnerships, in contrast, is taxed only once, at the personal tax rates of the firms' owners.

Over time, the distinction between S corporations and partnerships has blurred. Nevertheless, a C corporation electing to change its filing status to that of an S corporation receives preferential tax treatment compared with a C corporation that converts to a partnership. Converting to an S corporation is tax-free in many circumstances; converting to a partnership is taxable and requires the corporation to "recognize" (include in its taxable income) any built-in gain on its assets and the shareholders to recognize any such gain in their corporate stock. Under section 1374 of the Internal Revenue Code, if a C corporation converts to an S corporation, the appreciation of the firm's assets while it was a C corporation is not subject to the corporate-level tax—unless the assets are sold within 10 years of the conversion. Thus, current law allows a C corporation to avoid the two-tiered corporate tax by converting tax-free to an S corporation.

This option would repeal tax-free conversions for corporations with a value of more than $5 million at the time of conversion. Thus, when a C corporation with a value of over $5 million converted to an S corporation, the corporation and its shareholders would immediately recognize the gain in their appreciated assets. This option would increase income tax revenues by $0.8 billion over the 2002-2011 period.

Proponents of this option argue that repealing tax-free conversions by C corporations would treat economically similar conversions—from two-tiered corporate tax systems to single-tiered systems—in the same way. That equalization would, in turn, make tax considerations less important in decisions about the legal form that a firm might take. People who think S corporations more closely resemble corporations than they do partnerships may consider it beneficial to preserve the current differential tax treatment. According to that viewpoint, current law merely allows a corporation to change its filing status from that of a C corporation to an S corporation, providing it meets the legal requirements, without having to pay tax for choosing a different corporate form.

REV-44 Repeal the Expensing of Certain Agricultural Costs

	Added Revenues (Billions of dollars)
2002	0.4
2003	2.3
2004	1.2
2005	0.5
2006	0.3
2002-2006	4.7
2002-2011	5.3

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-35, REV-37, and REV-39

Like its treatment of some of the costs of producing timber, the current tax code allows most farmers—except farm corporations, partnerships, and tax shelters—to "expense," or deduct in the current year, certain capital outlays and costs of production, even when such investments generate income over several years. That tax treatment contrasts with the rules for depreciation and uniform capitalization that apply to most other industries, which deduct those costs more slowly. (See options REV-35, REV-37, and REV-39 for other exceptions.)

Agricultural expenses qualifying for immediate deduction include purchases of tools; the costs of breeding, feeding, and raising livestock; certain expenses for soil and water conservation; purchases of fertilizer; and the costs of developing and planting crops that require two years or less between planting and harvesting. In many cases, such investments produce income over more than a single tax year. Expensing those costs understates income in the year they are deducted. As a result, farmers are allowed to defer income taxes that they would otherwise have paid. This option would repeal the expensing of those agricultural costs, raising $5.3 billion in revenues from 2002 through 2011.

The Congress has acted in the past to restrict expensing within some industries. For example, the Tax Reform Acts of 1976 and 1986 limited its use by farm corporations and tax-shelter operations. In addition, the 1986 act established the uniform capitalization rules, which require most other types of businesses to deduct their costs for producing and reselling more slowly than they had previously. Thus, current law on the expensing of agricultural costs favors the production of small farms over that of larger ones and the agriculture industry in general over most other industries. That kind of tax preference raises issues of equity and can cause society's resources to be inefficiently allocated. Subjecting all farms to the normal rules for depreciation and uniform capitalization would treat businesses and industries similarly for tax purposes and help neutralize the tax system's effects on economic decisions. (It would not entirely neutralize those effects, however, because agriculture receives other special tax treatment.)

The original justification for expensing the costs of agricultural production was to simplify financial recordkeeping by farmers. Although the administrative costs of recordkeeping are clearly lower today than they used to be, opponents of this option would point out that it might still be simpler for farmers to deduct costs in one period rather than over several periods.

REV-45 Eliminate the Exemption of Income for Cooperatively Owned Electric and Telephone Utilities

	Added Revenues (Billions of dollars)
2002	0.2
2003	0.3
2004	0.3
2005	0.3
2006	0.3
2002-2006	1.4
2002-2011	3.3

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

270-05, 270-06, 270-07, 270-11, REV-40, and REV-46

RELATED CBO PUBLICATIONS:

Should the Federal Government Sell Electricity? (Study), November 1997.

Electric Utilities: Deregulation and Stranded Costs (Paper), October 1998.

Electric and telephone cooperatives, which are owned by their customers, are effectively or explicitly exempt from corporate income tax. They pay no tax on the portion of their income that they are required to distribute as dividends to their members, and they pay no tax on earnings from other sources, as long as at least 85 percent of their income comes from members for providing their primary service (electricity or telephone). Moreover, some forms of outside income—including rental income from telephone poles that are leased to cable or telephone companies and income from the Yellow Pages, cable TV, and Internet access—are not even counted toward the remaining 15 percent.

Eliminating those exemptions, which essentially provide subsidies to electric and telephone cooperatives, and taxing the co-ops as ordinary for-profit corporations would raise $0.2 billion in 2002 and $3.3 billion over the 2002-2011 period. In addition to exempting the co-ops' income from the corporate income tax, current law does not tax their distributions of dividends to members—whether as cash or as payments in kind in the form of household utility services. Eliminating that exemption could generate additional revenues.

The tax breaks given to co-ops, along with the low-interest loan program available through the Rural Utilities Service (see option 270-05), were created to encourage the wiring of rural areas for service. But now that most of the nation has telephone service, and with the advent of cell phones, there is little justification for subsidizing such wiring. As for electricity, most of the United States is already connected to the nationwide electricity grid, and the cost to distributors of providing electricity is probably the same for rural and urban customers. Moreover, all electric cooperatives receive the subsidies, even generation cooperatives that do not need them (because generating electricity does not cost more in rural areas). Finally, the market for electricity has been partially deregulated in the past few years. Continuing to provide this tax exemption in a more competitive environment gives cooperatives an advantage over utilities that are investor owned and that pay corporate income taxes.

Arguing against this option are its consequences for the co-ops' customers. If the tax exemption is withdrawn and cooperatively owned electric and telephone utilities must pay the same corporate income tax that other suppliers of electricity pay, then rates to the cooperatives' customers may rise. Ending the exemption would also raise issues related to equity. Subjecting electric and telephone co-ops to taxes that most other co-ops do not pay would treat some kinds of firms more favorably than other, similar operations.

REV-46 Eliminate the Exemption of Interest Income on Debt Issued by State and Locally Owned Electric Utilities for New Generating or Transmitting Facilities

	Added Revenues (Billions of dollars)
2002	a
2003	0.1
2004	0.1
2005	0.1
2006	0.2
2002-2006	0.5
2002-2011	2.0

SOURCE: Joint Committee on Taxation.

a. Less than $50 million.

RELATED OPTIONS:

270-05, 270-06, 270-07, 270-11, REV-40, and REV-45

State and locally owned utilities, as well as a small number of investor-owned utilities, issue tax-exempt bonds to finance the generation and transmission of electricity. Because the interest utilities pay on those bonds is not taxed, investors are willing to accept a lower yield than they would otherwise require to purchase those securities. By allowing some utilities to finance new generating and transmitting facilities through tax-exempt bonds, the tax code treats those utilities more favorably than others—for example, most cooperatively and investor-owned utilities that must issue taxable debt, on which investors require a higher rate of interest. This option would eliminate the exemption and tax the interest earned on bonds used by state and locally owned utilities to finance new generation or transmission facilities. It would raise about $2 billion over the 2002-2011 period.

State and locally owned utilities also use tax-exempt bonds to finance the distribution and retailing of electricity. This option does not apply to bonds for those purposes, although eliminating those tax exemptions could generate additional revenues. The option also does not apply to outstanding bonds that were used to finance existing generation and transmission facilities.

The market for electricity is becoming increasingly competitive. Many states have already deregulated the generation sector of the electricity industry, allowing customers to choose their electricity supplier. More states are expected to deregulate in the future. Utilities that have access to tax-exempt financing have a lower cost of capital than do other providers of electricity. By using that lower-cost capital to cut prices to their customers, such utilities not only encourage consumers to use more electricity than they would otherwise have used but also gain an advantage over other utilities in competing for customers. Utilities with access to lower-cost capital that did not use it to cut prices would probably use it to subsidize other public services or support inefficient techniques for producing electricity.

Proponents of maintaining the tax exemption argue that if it ended and state and locally owned utilities paid the same interest rate to attract capital for generation and transmission that other electricity suppliers pay, the rates charged for electricity by publicly owned utilities might rise. In addition, some people argue that the low cost of capital is necessary to finance universal service or affordable electricity rates for some disadvantaged groups.

REV-47 Increase the Excise Tax on Cigarettes by 50 Cents per Pack

	Added Revenues (Billions of dollars)
2002	5.3
2003	6.9
2004	6.9
2005	6.9
2006	6.9
2002-2006	32.9
2002-2011	67.9

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-49

RELATED CBO PUBLICATIONS:

Federal Taxation of Tobacco, Alcoholic Beverages, and Motor Fuels (Study), August 1990.

The Proposed Tobacco Settlement: Issues from a Federal Perspective (Paper), April 1998. (The proposal discussed in that publication does not reflect the final settlement.)

Taxes on certain goods and services can influence consumers' choices, causing people to purchase less of the taxed items. That taxation generally leads to a less efficient allocation of society's resources unless some of the costs associated with the taxed items are not reflected in their price. Tobacco is one such product that creates "external costs" to society that are not reflected in its pretax price—for example, higher costs for health insurance to cover the medical expenses linked to smoking and the effects of cigarette smoke on the health of nonsmokers. Taxes increase prices and can result in consumers' paying the full cost (including the external costs) of smoking. Increased taxes have also been shown to reduce the consumption of tobacco. Researchers estimate that each 10 percent increase in cigarette prices is likely to lead to a decline in cigarette consumption of 2.5 percent to 5 percent, probably with a larger decline for teenagers.

Tobacco is taxed by both the federal government and the states. Currently, the federal cigarette excise tax is 34 cents per pack; it will increase to 39 cents in 2002. (Other tobacco products have similar taxes.) State excise taxes averaged about 42 cents per pack in 2000. In addition, settlements reached between state attorneys general and major tobacco manufacturers require payments of fees equivalent to an excise tax of about 45 cents per pack.

Federal tobacco taxes raised about $5.4 billion in fiscal year 1999, or about 0.3 percent of total federal revenues. Several bills introduced in the 105th Congress proposed raising the excise tax, and in his budget for 2001, President Clinton proposed an increase of 25 cents per pack. This option would increase the cigarette tax by 50 cents a pack in addition to the scheduled increases, boosting net revenues by about $68 billion between 2002 and 2011.

No consensus exists about the magnitude of the external costs of smoking, which makes it difficult to judge the efficiency of tobacco taxes. Some economists estimate that the external costs of smoking are significantly less than the taxes and settlement fees now levied on tobacco; others think that the external costs are greater and that taxes should be increased even more. Technical issues cloud the debate; for example, the effect of secondhand smoke on people's health is uncertain. Much of the controversy centers on varying theories about what to include in figuring external costs—such as whether to consider tobacco's effects on the health of smokers' families or the savings in spending on public health and pensions that result from smokers' shorter lives. Nevertheless, increasing excise taxes may be desirable regardless of the magnitude of external costs if consumers underestimate the harm of smoking or the addictive power of nicotine. Teenagers, especially, may not be prepared to evaluate the long-term effects of beginning to smoke, although all populations know that smoking has health risks.

Arguing against taxes on tobacco is their regressivity; that is, such taxes take up a greater percentage of the earnings of low-income families than of middle- and upper-income families. That imbalance occurs because lower-income people are more likely to smoke and because expenditures on cigarettes for those who smoke do not rise appreciably with income.

REV-48 Increase All Alcoholic Beverage Taxes to $16 per Proof Gallon

	Added Revenues (Billions of dollars)
2002	4.0
2003	4.7
2004	4.8
2005	4.8
2006	4.8
2002-2006	23.1
2002-2011	47.4

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-49

RELATED CBO PUBLICATION:

Federal Taxation of Tobacco, Alcoholic Beverages, and Motor Fuels (Study), August 1990.

In terms of the tax per ounce of ethyl alcohol, current federal excise taxes treat alcoholic beverages in different ways. Levies remain much lower on beer and wine than on distilled spirits, and they are figured on different liquid measures. Distilled spirits are measured in proof gallons, a standard measure of a liquid's alcohol content; the current rate of $13.50 per proof gallon results in a tax of about 21 cents per ounce of alcohol. Beer, however, is measured by the barrel, and the current rate of $18 per barrel leads to a tax of about 10 cents per ounce of alcohol (assuming an alcohol content for beer of 4.5 percent). The current levy on table wine is $1.07 per gallon and results in a tax of about 8 cents per ounce of alcohol (assuming an average alcohol content of 11 percent). In fiscal year 1999, federal excise taxes on distilled spirits, beer, and wine raised approximately $7.7 billion.

This option would standardize the base on which the federal excise tax is levied and use the proof gallon as the measure for all alcoholic beverages. It would also increase the tax to $16 per proof gallon, raising about $47 billion between 2002 and 2011. A tax of $16 per proof gallon comes to about 25 cents per ounce of ethyl alcohol. It would raise the tax on a 750-milliliter bottle of distilled spirits from about $2.14 to $2.54, the tax on a six-pack of beer from about 33 cents to 81 cents, and the tax on a 750-milliliter bottle of table wine from about 21 cents to 70 cents.

The consumption of alcohol creates costs to society that are not reflected in the pretax price of alcoholic beverages. Examples of those "external costs" include costs related to health care that are covered by the public, losses in productivity that are borne by others, and the loss of lives and property in alcohol-related accidents and crime. Calculating such costs raises both practical and theoretical difficulties, but a study reported by the National Institute on Alcohol Abuse and Alcoholism estimated that the external economic costs of alcohol abuse exceeded $100 billion in 1998.

Raising the price of alcoholic beverages through a hike in excise taxes would reduce the external costs of alcohol use and lead consumers to pay a larger share of those costs. Studies consistently show that higher prices lead to lower consumption and less abuse of alcohol, even among heavy drinkers. Moreover, boosting excise taxes to reduce consumption may be desirable regardless of the effect on external costs if consumers are unaware of or underestimate either the harm that their drinking does to them and others or the extent of the addictive qualities of alcohol.

Yet taxes on alcoholic beverages have their downside as well. They are regressive when compared with annual family income; that is, such taxes take up a greater percentage of income for low-income families than for middle- and upper-income families. In addition, taxes on alcohol fall not only on problem drinkers but also on drinkers who impose no costs on society and are thus unduly penalized. Taxes are also likely to reduce consumption by some light drinkers whose intake of alcohol might produce beneficial health effects.

REV-49 Index Tobacco and Alcohol Tax Rates for Inflation

	Added Revenues (Billions of dollars)
2002	0.3
2003	0.8
2004	1.1
2005	1.4
2006	1.8
2002-2006	5.4
2002-2011	18.7

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-47 and REV-48

RELATED CBO PUBLICATIONS:

Federal Taxation of Tobacco, Alcoholic Beverages, and Motor Fuels (Study), August 1990.

The Proposed Tobacco Settlement: Issues from a Federal Perspective (Paper), April 1998. (The proposal discussed in that publication does not reflect the final settlement.)

Federal alcohol and tobacco taxes raised over $13 billion in fiscal year 1999, including about $7.7 billion from taxes on distilled spirits, beer, and wine and about $5.4 billion from taxes on tobacco. Together those taxes represented nearly one-fifth of the revenues from all excise taxes and almost 0.7 percent of total federal revenues. Tobacco and alcohol excise taxes are currently imposed on a per-unit basis (such as on a pack of cigarettes or bottle of wine). Their real cost (after adjusting for the effects of inflation) has declined as inflation has risen because increases in tax rates have not kept pace with the growth in prices. For example, despite several small legislative increases, excise taxes on distilled spirits have dropped by nearly 80 percent in real terms since 1951.

One way to prevent inflation from eroding real tax rates is to index the rates—that is, tie increases in them to increases in prices. Indexing the rates of excise taxes on tobacco and alcoholic beverages would raise almost $19 billion in the 2002-2011 period and avoid the need for abrupt nominal increases in the future.

The pretax prices of tobacco and alcoholic beverages cover the costs manufacturers incur to produce and distribute their goods. But smoking and drinking create other, "external" costs to society that those prices do not reflect. Examples include medical expenses linked to smoking and drinking that are covered by the public, the effects of cigarette smoke on the health of nonsmokers, and the loss of lives and property in alcohol-related accidents.

By raising the price of tobacco and alcoholic beverages, excise taxes can help lower consumption of those products, which will reduce the external costs of smoking and drinking. In addition, increasing excise taxes can lead to consumers paying a larger share of the costs of those activities. If the external costs of smoking and drinking come mainly from heavy or abusive consumption by a minority of consumers, however, higher excise taxes could unduly penalize moderate and occasional smokers and drinkers. A further drawback is that taxes on tobacco and alcoholic beverages are regressive when compared with annual family income, accounting for a greater percentage of the earnings of low-income families than of middle- and upper-income families. In recent years, tobacco taxes have become increasingly regressive as the smoking rate has declined faster among wealthier than among less affluent groups.

An alternative to indexing would be to convert excise taxes to ad valorem taxes, which equal a percentage of the manufacturer's price. That method would link tax revenues to price increases; specifically, it would tie revenues to the price of the taxed goods and not to the level of overall prices. Indexing would mitigate a shortcoming of the ad valorem tax, which is that it creates incentives for manufacturers to reduce the taxes they owe by artificially lowering the prices they charge company-controlled wholesalers.

REV-50 Increase Excise Taxes on Motor Fuel by 12 Cents per Gallon

	Added Revenues (Billions of dollars)
2002	11.8
2003	15.9
2004	15.8
2005	15.9
2006	16.2
2002-2006	75.6
2002-2011	163.2

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

270-08 and REV-38

RELATED CBO PUBLICATION:

Federal Taxation of Tobacco, Alcoholic Beverages, and Motor Fuels (Study), August 1990.

Federal taxes on motor fuel, which are used to finance highway construction and maintenance, are currently 18.4 cents per gallon of gasoline and 24.4 cents per gallon of diesel fuel. This option would raise those taxes by 12 cents per gallon, increasing revenues by almost $12 billion in 2002 and slightly more than $163 billion over the 2002-2011 period. The total federal tax on gasoline under the option would be 30.4 cents per gallon. To bolster the overall budget surplus, the Congress could allocate the additional revenues to the general fund rather than use them to finance further spending on highways.

Imposing new or higher taxes on petroleum could have several beneficial effects. For example, making petroleum more expensive could encourage conservation and reduce pollution. Higher prices might encourage people to drive less or to purchase more fuel-efficient cars and trucks. Less consumption of motor fuel would also lessen carbon dioxide emissions and could therefore help slow global warming. A further benefit is that the tax would offset, though imperfectly, the costs of pollution and road congestion that automobile use engenders.

Increasing tax rates on motor fuels raises some issues of fairness, however. It would impose an added burden on the trucking industry and on people who commute long distances by car, groups that are not necessarily the highway users who impose the greatest costs of pollution and congestion on others. Such costs are much higher in densely populated areas, primarily in the Northeast and coastal California, whereas the amount of motor fuel consumed per person is greatest in rural areas. In addition, taxes on gasoline and other petroleum products are regressive: they take up a greater percentage of income for lower-income families than for middle- and upper-income families.

REV-51 Replace Existing Excise Taxes on Heavy Vehicles with a Tax Based on Weight and Distance Traveled

Heavier vehicles impose disproportionately larger costs on the nation's highway system than do lighter vehicles. Vehicles that carry passengers cost less than a penny, on average, for each mile they travel compared with almost 7 cents per mile for the average combination truck (for example, a tractor-trailer or a tractor-semitrailer). Road maintenance and repair costs rise with the weight of a vehicle; however, among vehicles of comparable weight, those with more axles impose lower costs. Owners of heavy vehicles currently pay the tax levied on diesel fuels and three other federal excise taxes: a retail sales tax of 12 percent on new trucks and trailers, a yearly use tax on heavy vehicles, and a tax paid by the manufacturer on tires for heavy vehicles. Taken together, the taxes on heavy vehicles do not effectively match a heavy vehicle's tax liability with the damage it does to roads. Some heavy vehicles pay more than their share of those costs, while others pay less. This option would replace the three existing excise taxes with a single per-mile tax based on a vehicle's weight and number of axles, which would better align the taxes a truck pays with the damage it does to roads. Because that single tax could be structured to be revenue neutral or to increase tax collections, no table is shown.

Existing excise taxes fail to effectively match a vehicle's tax burden with its cost to the nation's highways. The manufacturer's tax on tires comes the closest to aligning taxes with costs. First, it is levied only on tires for heavy vehicles. Second, it is related to the distance a truck travels, because the more miles that are driven, the sooner the tire must be replaced. In contrast, the 12 percent retail sales tax that the government levies on the purchase of new trucks is unrelated to how far they drive or how much they cost the highway system. Indeed, that tax may actually discourage people from purchasing newer, more fuel efficient trucks. And the use tax on heavy vehicles applies to all trucks weighing more than 75,000 pounds and does not vary with annual mileage. Thus, despite the vastly different costs they impose on highways, a vehicle weighing 140,000 pounds and traveling 100,000 miles annually pays the same use tax as a vehicle weighing 80,000 pounds and traveling only 10,000 miles.

Proponents of substituting a single tax based on weight and distance for the three existing excise taxes see several benefits to such a change. First, a weight/distance tax would make vehicles pay for the costs they actually inflict on highways. Heavier vehicles would pay more than lighter vehicles, and, within weight categories, vehicles with more axles would pay less per mile (since they cause less damage). Second, replacing three taxes with a single levy would simplify the tax code. Third, the transition to the new tax regime would be relatively simple because operators of heavy vehicles already record the gross weight of their truck, the number of miles they travel annually, and the number of the truck's axles—the information needed to administer the tax. Finally, eliminating the three existing excise taxes would mitigate some of the adverse economic consequences associated with those taxes. For example, the retail sales tax would no longer discourage people from purchasing new and more energy efficient vehicles.

Opponents argue against this option on several grounds. The new tax regime would not perfectly link a vehicle's taxes to the damage it did to highways. The tax would be assessed on a vehicle's gross weight (usually, the weight when fully loaded). Tying the tax to gross weight would lead to overpayment for the miles driven when the truck was empty and underpayment for the miles driven when it was overloaded (which occasionally occurs in the truck industry). Furthermore, the option's imperfect alignment of taxes and costs would encourage even more overloading.

REV-52-A Tax Water Pollutants on the Basis of Biological Oxygen Demand

	Added Revenues (Billions of dollars)
2002	1.9
2003	2.7
2004	2.6
2005	2.5
2006	2.4
2002-2006	12.1
2002-2011	23.3

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-52-B, REV-53-A, REV-53-B, REV-53-C, and REV-53-D

The Clean Water Act (CWA), which was last amended in 1987, requires all municipal and industrial wastewater to be treated to protect the quality of the nation's water. The regulations written to implement the act cover all facilities that discharge wastewater—and the effluents, or pollutants, it contains—directly into water or indirectly into sewer systems; they specify the use of pollution-abatement technology or impose limits on the concentrations of pollutants that may be discharged. The CWA prohibits those facilities (sometimes referred to as point sources) from discharging pollutants without a permit. Under the CWA, a permit requires the point source to attain certain technology-based limits on the effluents in its discharges, to record discharge volumes, and to monitor effluent levels. In general, facilities that are subject to water pollution standards do not pay taxes or fees based on effluents that the regulations allow them to discharge.

The CWA also requires states, tribes, and other jurisdictions to evaluate water quality conditions in their areas and submit reports to the Environmental Protection Agency every two years. According to the 1998 evaluation, about 40 percent of the rivers, lakes, and estuaries that the reports covered failed to meet water-quality standards at some time during that year. (Authorities judged a body of water as failing if it was not clean enough to support basic uses, such as swimming and fishing.) Organic water pollutants, as they decompose, contribute to that failure by depleting the oxygen in the water, which is necessary to sustain fish and other aquatic life. Biological oxygen demand (BOD) measures the intensity of oxygen-demanding wastes in water. (One BOD equals 1 milligram of oxygen consumed per 2.2 pounds of effluent.) Most of the large-volume dischargers of effluents with high levels of BOD include such point sources as publicly owned treatment works (POTWs), paper and pulp mills, food processors, metal producers, and chemical plants. Discharges by point sources total about 16.6 million pounds of effluent per day; POTWs discharge about 8.4 million pounds of that amount. The cost of abating pollution in discharges from POTWs and many industries that are regulated under the CWA averages about 50 cents to 75 cents per pound of effluent removed.

This option would tax water pollutants on the basis of their biological oxygen demand. Such a tax on levels of BOD could encourage manufacturing facilities and POTWs to reduce the pollutants they now discharge. For effluents with an average concentration of 22 BOD, a tax of 66 cents per pound of effluent discharged would raise about $12 billion from 2002 through 2006 and about $23 billion over the 2002-2011 period.

Several arguments could be made supporting such a tax. First, a tax on pollution would tend to discourage activities that impose costs on society. In economic terms, it would also increase welfare if the additional abatement costs were less than or equal to the social benefits from reduced levels of pollution. Second, an excise tax on BOD could increase the level of pollution control in a cost-effective (least-cost) manner—by encouraging firms with the lowest abatement costs to reduce pollution and by allowing firms with high abatement costs to continue discharging pollutants and paying the tax. Third, the costs of administering an excise tax based on BOD water pollution would be small: allowable levels of BOD discharges are specified in the permits issued to dischargers under the CWA. Finally, imposing a tax on one class of pollutants (BOD) might reduce others as well, because some wastewater treatment processes reduce several pollutants simultaneously.

Levying a tax on effluents from POTWs and large industrial dischargers would ensure that the tax base included all of the large-volume dischargers with high levels of BOD. Such a broad-based tax, however, might raise constitutional issues about federal taxation of the local governments that operate POTWs. In that case, POTWs (or a federal authority) could collect the tax directly from polluters that discharge wastewater into municipal sewer systems.

REV-52-B Impose a Tax on Toxic Water Pollutants

	Added Revenues (Billions of dollars)
2002	0.2
2003	0.3
2004	0.2
2005	0.2
2006	0.2
2002-2006	1.1
2002-2011	2.1

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-52-A, REV-53-A, REV-53-B, REV-53-C, REV-53-D, and REV-55

RELATED CBO PUBLICATION:

Decreasing the Discharge of Bioaccumulative Toxic Water Pollutants: A Policy Analysis (Memorandum), December 1992.

Taxes on large facilities that discharge pollutants into the nation's waterways can both raise revenues and provide incentives for firms to reduce pollution cost-effectively (see option REV-52-A). Harmful levels of toxic chemicals and metals in the water are a key concern: because those substances do not readily break down in natural ecosystems, they may accumulate, threatening both the aquatic environment and human health. Toxic pollutants generally include organic chemicals (such as solvents and dioxins), metals (such as mercury and lead), and pesticides. In 1998, manufacturers in the United States discharged 234 million pounds of toxic substances directly into water and 273 million pounds indirectly into water through sewers. One option for increasing revenues and encouraging firms to reduce pollution is to impose a tax on such companies.

The Environmental Protection Agency (EPA) has devised a weighing method to indicate the toxicity of various pollutants. That system makes it possible to measure the quantities of different types of toxic pollutants by their "toxic pound equivalents," which the EPA defines as the pounds of a pollutant multiplied by its toxic weight. This option adopts tax rates developed by the Congressional Research Service (CRS) in a study on the discharges of manufacturing firms in 1987. CRS defined five categories of pollutants on the basis of their toxicities. The tax rates varied from 65 cents per pound for the least toxic category to $63.40 per pound for the most toxic. (Variable rates give firms an incentive to reduce their most toxic discharges.) Those rates correspond to a charge of $32.35 for the equivalent of each toxic pound. According to the EPA, the cost of controlling one additional toxic pound varies among industries, ranging from $1.50 to $606.00 (in 1991 dollars). The tax, therefore, could encourage industries and firms with low costs for abatement to reduce their toxic discharges. It would also raise $2.1 billion in revenues from 2002 through 2011.

Administering the tax would present few substantive difficulties. To assess tax payments, the Internal Revenue Service could use information from the EPA's Toxic Release Inventory (TRI) on toxic discharges by manufacturing firms. Alternatively, the EPA could collect the tax on behalf of the Internal Revenue Service. An important consideration, however, is the questionable accuracy of TRI data. The inventory contains self-reported data, and many facilities that are required to file reports either fail to file them or file inaccurate ones. To improve the accuracy of the TRI database and enforce payment of the tax, frequent auditing would be necessary.

REV-53-A Impose a Tax on Sulfur Dioxide Emissions

	Added Revenues (Billions of dollars)
2002	0.5
2003	0.8
2004	0.7
2005	0.7
2006	0.6
2002-2006	3.3
2006-2011	6.0

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-52-A, REV-52-B, REV-53-B, REV-53-C, REV-53-D, REV-54, and REV-55

RELATED CBO PUBLICATION:

Factors Affecting the Relative Success of EPA's NO_x Cap-and-Trade Program (Paper), June 1998.

Under the Clean Air Act, the Environmental Protection Agency (EPA) sets national standards for ambient air quality that are designed to protect the public's health and welfare. The EPA defines acceptable levels for six "criteria" air pollutants: sulfur dioxide (SO_2), nitrogen oxides (NO_x), ozone, particulate matter, carbon monoxide (CO), and lead. Along with emissions from natural sources, emissions of air pollutants from stationary sources (such as industrial facilities and commercial operations) and mobile sources (automobiles, trains, and airplanes) contribute to the ambient levels of those criteria pollutants.

Sulfur dioxide belongs to the family of sulfur oxide gases formed during the burning of fuel containing sulfur (mainly coal and oil) and during metal smelting and other industrial processes. Exposure to high concentrations of SO_2 may promote respiratory illnesses or aggravate cardiovascular disease. In addition, SO_2 and NO_x emissions are considered the main cause of acid rain, which the EPA believes degrades surface waters, damages forests and crops, and accelerates corrosion of buildings.

The Clean Air Act Amendments of 1990 adopted a program to control acid rain that introduced a market-based system of emission allowances to reduce SO_2 emissions. An emission allowance is a limited authorization to emit a ton of SO_2. The EPA allots tradable allowances to affected electric utilities according to the utilities' past fuel use and statutory limits on emissions. Once the allowances are allotted, the act requires that annual SO_2 emissions not exceed the number of allowances held by each utility plant. Firms may trade allowances, bank them for future use, or purchase them through periodic auctions held by the EPA. Firms with relatively low costs for abating pollution have an economic incentive to reduce their emissions and sell surplus allowances to firms that have relatively high abatement costs.

This option would tax emissions of SO_2 from stationary sources not already covered under the acid rain program. If the federal government imposed a tax of $200 per ton of SO_2 emissions from those sources, it would raise about $6 billion over the 2002-2011 period.

With some minor exceptions, firms that are subject to air pollution standards must incur the costs of reducing emissions to comply with regulations. Most firms that would be affected by this tax do not, however, pay taxes or fees on emissions that the Clean Air Act still allows. Major sources of pollutants do pay user fees to cover the costs of a program providing operating permits (stating which air pollutants a source is allowed to emit) under the 1990 amendments to the act. Basing the tax described in this option on the terms granted in the permits would minimize the Internal Revenue Service's costs of administering the option.

In general, taxes on emissions can help reduce pollution in a cost-effective (least-cost) manner. Such taxes encourage firms with the lowest costs for abatement to reduce their emissions and, at the same time, allow firms with high abatement costs to continue emitting pollutants and paying the tax. Specifically, firms would have an incentive to reduce the taxed pollutant up to the point at which the tax just equals the cost of eliminating an additional ton of pollutant. This option, as well as options REV-53-B, REV-53-C, and REV-53-D, would base tax rates on the estimated average cost of reducing that additional ton. Consequently, some firms with lower-than-average costs for abatement might reduce their pollution levels below the allowable standards. Opponents of this kind of tax, however, argue that it would impose a burden on many firms that already incur costs to comply with current regulations on emissions.

REV-53-B Impose a Tax on Nitrogen Oxide Emissions

	Added Revenues (Billions of dollars)
2002	6.8
2003	9.8
2004	9.3
2005	9.0
2006	8.8
2002-2006	43.7
2002-2011	85.7

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-52-A, REV-52-B, REV-53-A, REV-53-C, REV-53-D, REV-54, and REV-55

RELATED CBO PUBLICATION:

Factors Affecting the Relative Success of EPA's NO_x Cap-and-Trade Program (Paper), June 1998.

Nitrogen oxides (NO_x) usually enter the air as the result of high-temperature combustion processes such as those found in automobiles and power plants. Emissions of NO_x play an important role in the atmospheric reactions that generate ground-level ozone (smog) and acid rain. Moreover, the Environmental Protection Agency (EPA) believes that NO_x can irritate the lungs and lower resistance to respiratory infections such as influenza. Nitrogen oxides and pollutants formed from them can be transported over long distances, so problems associated with NO_x are not confined to areas where they are emitted.

The Clean Air Act requires states to implement programs to reduce ground-level ozone. Because of the transportability of NO_x and ozone, the act requires upwind states to establish programs that will help downwind states meet statutory standards. In 1998, the EPA promulgated the Ozone Transport Rule, which required 22 northeastern states and the District of Columbia to revise their programs to further reduce NO_x emissions. The rule did not mandate specific methods but instead gave each affected state a target for NO_x emissions. The goal of the rule was to have programs in place by 2003 that would reduce NO_x emissions by about 1.2 million tons in the affected states by 2007. Implementation of the rule was delayed for about a year because of court challenges but is now going forward.

Another way to help control NO_x would be to tax emissions from stationary sources such as industrial facilities and commercial operations. Controlling NO_x from those sources costs between $600 and $10,000 per ton of emissions abated. Imposing a tax of $1,500 per ton on NO_x emissions from stationary sources would encourage facilities with lower costs for abatement to try to further reduce their polluting. (For example, firms might adopt currently available techniques for abatement whose capitalized costs were lower than the tax they would otherwise pay.) A tax of $1,500 per ton would raise over $85 billion from 2002 to 2011.

In guidelines that the EPA provided to the affected states for implementing the Ozone Transport Rule, it encouraged states to set up a regional-level program for trading NO_x allowances similar to the national trading program for sulfur dioxide allowances (see option REV-53-A). Such a program could be structured to encourage firms with relatively low costs for abatement to reduce their emissions and sell surplus NO_x allowances to firms with relatively high pollution-abatement costs. If a regional program for trading allowances was put into place, another option would be to tax only the stationary sources of NO_x that did not participate in the program. If the rate of participation in the program was high, such a tax would raise about $39 billion over the 2002-2011 period.

Proponents of taxing pollution argue that such taxes discourage activities that impose costs on society and could increase the level of control in a cost-effective (least-cost) manner. Further, the lower emissions that such taxes produced would increase the welfare of society if the additional costs for abatement were less than or equal to the social benefits from reduced pollution. Opponents argue, however, that such a tax would impose an additional burden on many firms that are already incurring costs to comply with current regulations. They also contend that the tax's added cost to firms might be greater than the added benefits that society would gain from less pollution. Arriving at some certainty about that issue is difficult, though, because of the questions associated with methods for estimating the additional social benefits from reducing pollution levels.

REV-53-C Impose a Tax on Emissions of Coarse Particulate Matter

	Added Revenues (Billions of dollars)
2002	0.5
2003	0.7
2004	0.7
2005	0.6
2006	0.6
2002-2006	3.1
2002-2011	6.1

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-52-A, REV-52-B, REV-53-A, REV-53-B, REV-53-D, REV-54, and REV-55

Particulate matter (PM) is the general term used for a mixture of solid particles and liquid droplets found in the air. Those particles come in a wide range of sizes: fine particles are less than 2.5 micrometers in diameter, and coarse particles are larger than 2.5 micrometers. The particles originate from various manmade stationary and mobile sources as well as from nature. Fine particles result from fuel combustion in motor vehicles, power generation, and industrial facilities as well as from residential fireplaces and wood stoves. Coarse particles are generally emitted from power plants and factories and such sources as vehicles traveling on unpaved roads, materials handling, crushing and grinding operations, and windblown dust. Some particles are emitted directly from such sources as smokestacks and cars. In other cases, sulfur dioxide (SO_2), nitrogen oxides (NO_x), and volatile organic compounds interact with other compounds in the air to form PM.

According to Environmental Protection Agency (EPA) studies, emissions of PM (alone or combined with other air pollutants) are linked to some adverse effects on people's health. For example, particulate matter can carry heavy metals and cancer-causing organic compounds into the lungs, increasing the incidence and severity of respiratory diseases. Other effects on health may include increased hospital admissions and visits to the emergency room for respiratory-related illnesses and chronic bronchitis.

In 1997, the EPA, under the authority of the Clean Air Act, finalized air quality standards for fine particulate matter and revised those for ozone and coarse particulate matter. But legal challenges ensued, and the standards have yet to be implemented. One option for controlling particulate matter and increasing revenues at the same time would be to tax emissions of coarse PM from stationary sources. A tax of $500 per ton of coarse PM emitted would raise about $6 billion from 2002 through 2011.

Taxing emissions of coarse PM would have advantages and disadvantages as a method for controlling pollution. On the plus side, taxes on emissions can help reduce pollution in a cost-effective manner (see option REV-53-A). For example, such taxes might lead some electric utilities and manufacturing plants to install improved electrostatic precipitators, wet scrubbers, or other equipment to reduce emissions and lower their tax burden. Reductions in emissions spurred by the tax would be economically efficient (lead to a higher level of economic activity) if the additional costs for abatement were lower than the benefits society derived from less pollution. Moreover, since a permit system is already in place for emissions of coarse PM, the tax could be implemented and administered relatively easily, using an approach similar to that proposed for emissions of sulfur dioxide (discussed in option REV-53-A) and nitrogen oxides (described in option REV-53-B).

On the minus side, opponents of a tax on emissions of coarse PM argue that it would impose an excessive burden on firms that already incur costs to comply with current standards. Furthermore, a tax on coarse PM might be regressive—meaning that it would fall more heavily on lower-income families than on higher-income ones—if it eventually raised the price of energy.

REV-53-D Impose a Tax on Volatile Organic Compounds

	Added Revenues (Billions of dollars)
2002	8.4
2003	12.0
2004	11.2
2005	10.6
2006	10.3
2002-2006	52.5
2002-2011	102.0

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-52-A, REV-52-B, REV-53-A, REV-53-B, REV-53-C, REV-54, and REV-55

Pollution in the form of ground-level ozone is a pervasive problem in many areas of the United States. Ozone is not emitted directly into the air; rather, it is produced by the reaction of volatile organic compounds (VOCs) and nitrogen oxides (NO_x) in the presence of heat and sunlight. Ozone occurs naturally in the stratosphere (the upper atmosphere) and provides a protective layer high above the Earth. At ground level, however, ozone is the prime ingredient of smog. Short-term exposures (one to three hours) to ambient concentrations of ozone have been linked to increased hospital admissions and emergency room visits for respiratory ailments. Repeated exposure to ozone may make people more susceptible to respiratory infections and inflammation of the lungs.

To control pollution from ozone, the Environmental Protection Agency (EPA) has traditionally focused on reducing emissions of VOCs (and, more recently, of NO_x). VOCs include chemicals such as benzene, toluene, methylene chloride, and methyl chloroform; they are released by burning fuel (gasoline, oil, wood, coal, natural gas, and the like) or using solvents, paints, glues, and other products. One option for reducing pollution from ozone is to tax emissions of VOCs from stationary sources, which range from huge industrial facilities, such as chemical plants, petroleum refineries, and coke ovens, to small sources, such as bakeries and dry cleaners. (See options REV-53-B and REV-54 on taxing emissions of NO_x and emissions from mobile sources, respectively.) The vast number and diversity of stationary sources make it difficult to estimate the amount of emissions they produce and the cost of abating that pollution. A tax of $2,100 per ton on all VOC emissions from stationary sources could promote abatement and would generate about $102 billion in revenues from 2002 through 2011.

The advantage of a broad-based tax on VOCs is that it would affect both large and small sources of the compounds. The EPA estimates that small sources account for a large portion of the emissions from stationary sources. However, because stationary facilities emitting less than 2.5 tons of VOCs per year are not currently subject to federal regulation, a broad-based tax on VOCs would be administratively harder to implement than a tax on the large sources alone. (States currently survey the large facilities and then turn over their data on emissions to the EPA.) Imposing the tax on small sources of VOCs through technology-based estimates of emissions rather than measured emissions would reduce administrative costs; at the same time, it would also somewhat reduce the incentive to emit less. A disadvantage of such a broad-based tax, however, is that it may be regressive, falling more heavily on lower-income families than on higher-income households.

REV-54 Impose a One-Time Tax on Emissions from New Automobiles and Light Trucks

	Added Revenues (Billions of dollars)
2002	2.1
2003	3.1
2004	3.1
2005	3.1
2006	3.1
2002-2006	14.5
2002-2011	30.0

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-53-A, REV-53-B, REV-53-C, and REV-53-D

The Clean Air Act Amendments of 1990 strengthened the provisions of the earlier law that sought to reduce emissions from mobile sources of pollution. The amendments raised the tailpipe standards for cars, buses, and trucks; they expanded inspection and maintenance programs to include more regions with pollution problems and to promote more stringent testing; and they introduced several regulations to reduce air pollution from mobile sources, including regulations for selling improved gasoline formulations in some polluted cities to reduce pollutant levels. In addition, the amendments provided new programs that tighten emission standards for vehicles to encourage the development of even cleaner cars and fuels.

Despite progress to date in controlling air pollution from motor vehicles, mobile sources continue to significantly affect the nation's air quality. Nationwide, highway motor vehicles on average account for over one-quarter of all emissions of volatile organic compounds (VOCs), almost one-third of nitrogen oxide (NO_x) emissions, and about 60 percent of carbon monoxide emissions. Taxing emissions of those pollutants from mobile sources could help reduce them by providing an additional incentive for consumers to purchase cleaner cars and trucks. One option would be to impose a one-time tax on new automobiles and light trucks. The tax could be based on the grams of VOCs (measured in grams of hydrocarbons), NO_x, and carbon monoxide that a vehicle emitted per mile as estimated by the emissions tests that the Environmental Protection Agency requires for every new vehicle. The tax could be administered like the current excise tax on luxury vehicles: the auto dealer would collect the tax on behalf of the Internal Revenue Service from the vehicle's purchaser.

Such a tax, which would average $275 for each new passenger car and light-duty truck sold, could raise about $30 billion in revenues from 2002 through 2011. A disadvantage of the option, however, is that it leaves out older vehicles, which account for a larger share of emissions from mobile sources than do new vehicles. A further drawback is that a one-time emissions tax would raise the prices of new vehicles and might therefore encourage people to delay purchasing them.

REV-55 Eliminate Tax Credits for Producing Unconventional Fuels and Generating Electricity from Renewable Energy Sources

	Added Revenues (Billions of dollars)
2002	1.1
2003	1.0
2004	0.7
2005	0.7
2006	0.8
2002-2006	4.3
2002-2011	5.5

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

270-01, 270-03, 270-08, REV-52-B, REV-53-A, REV-53-B, REV-53-C, and REV-53-D

Under current law, firms that produce unconventional fuels or generate electricity from certain renewable forms of energy can claim a credit against their income taxes. Section 29 of the Internal Revenue Code offers credits to businesses that produce natural gas from coal seams (know as coalbed methane), oil from shale and tar sands, gas from geopressured brine and Devonian shale, energy from biomass (including landfill methane), and synthetic fuels from coal. Section 45 of the code offers credits to producers of electricity from wind, closed-loop biomass (including landfill methane), and poultry waste.

The tax credits are essentially subsidies from the federal government (in the form of lower taxes), which may prompt some businesses to charge purchasers less for energy from those sources. Lower prices, in turn, may encourage people to substitute those sources for more conventional forms of energy. But little substitution has actually taken place, and only coalbed methane, landfill methane, and wind power have been commercially viable energy sources. Eliminating the credits would increase revenues by $5.5 billion over the 2002-2011 period.

The credits were initially enacted to promote energy security and efficiency (by encouraging consumers to use alternatives to imported petroleum as well as energy that would otherwise be lost) and to foster a cleaner environment (by encouraging the use of nonpolluting sources of energy). But proponents of eliminating the credits point out that the energy sources that benefit from them contribute very little to meeting the nation's energy requirements. Moreover, the limited success that markets for coalbed methane, landfill methane, and wind power have had is attributable more to such factors as technological advances, rising natural gas prices, other federal programs (such as the Environmental Protection Agency's New Source Performance Standards), and state subsidies than to the credits. Indeed, critics claim that, far from benefiting the environment, production of energy from some of the eligible sources causes environmental problems. (For example, wind rotors may endanger migratory birds, and coalbed methane production may harm groundwater.) In addition, the credits may reduce economic efficiency by encouraging the use of relatively expensive fuels. Finally, proponents of eliminating the credits believe that the goal of promoting a cleaner environment would be more efficiently achieved by imposing taxes on pollutants equal to the damage they cause.

Advocates of retaining the tax credits argue that they remain an important part of the national policy to promote development of new sources of energy. Moreover, they believe that the credits help curb wasteful and polluting practices. For example, capturing landfill methane as a fuel rather than venting it into the air reduces odors and other hazards associated with emissions of landfill gas. And encouraging the use of poultry waste as fuel may help reduce the negative consequences of traditional disposal, such as water pollution and unpleasant odors. To the extent that the tax credits encourage the use of renewable sources of energy, they may also help reduce global warming.